This Note provides a summary of the US federal income tax requirements that must be satisfied to achieve real estate investment trust (REIT) status, typical tax structures for REIT investments and the tax treatment of REITs engaging in various transactions.

While many states follow the US federal income tax treatment of REITs, a discussion of the state or foreign taxation of a REIT is beyond the scope of this Note.

For a checklist that provides a list of common pitfalls that can arise with REITs and how they can be fixed, see REITs: Common Pitfalls and Fixes Checklist (http://us.practicallaw.com/2-504-7119).

WHAT IS A REIT?
A REIT is an entity that satisfies certain US federal income tax requirements and elects to be taxed as a REIT. The tax requirements generally are designed to ensure that the REIT:
- Is a passive investor in real estate (and related assets).
- Does not retain its earnings.
- Is beneficially owned by a diversified stockholder base.

STATE LAW ENTITY CLASSIFICATION
There is generally no limit on the type of state law entity that can qualify as a REIT. While most REITs are formed as trusts or corporations, there may be state or foreign tax planning reasons to form a REIT as a partnership or LLC. However, a REIT must be a US entity. In addition, a REIT is treated as a corporation for tax purposes, regardless of its state law form (see Taxable as a US Corporation).

For more information about US business entities, see Choosing an Entity Comparison Chart (http://us.practicallaw.com/7-381-0701) and Practice Note, Choice of Entity: Tax Issues (http://us.practicallaw.com/1-382-9949).

PUBLIC OR PRIVATE REITs
A REIT can be publicly traded or privately held as long as it satisfies restrictions on ultimate beneficial ownership (see Beneficially Owned by 100 or More Persons). A REIT can also issue common equity, preferred equity and debt instruments.

TYPES OF REITs
A REIT can invest in different types of real estate assets or limit its investment activities to a particular class of permitted real estate investment. It can be:
- An equity REIT owning direct or indirect equity interest in real estate (including retail, commercial, residential and industrial real estate).
- A mortgage REIT investing in debt instruments secured by real estate.
- A hybrid REIT owning any combination of permitted debt and equity investments.
- A sector REITs that invests exclusively or primarily in a particular class of property. For example, a health care REIT generally invest only in properties leased for use as medical facilities or nursing homes (see Box, Hotel and Health Care REITs).
REITs: Overview

As will be discussed further below, one key exception to the type of real estate activities a REIT can engage in is the limitation on a REIT’s ability to earn income from so-called dealer activities, like the development and sale of condominiums (see Prohibited Transaction Income).

**BENEFITS OF REIT STATUS**

The benefits of REIT status are:

- No entity level tax even for publicly traded REITs.
- The ability to attract tax-exempt and foreign investors.

**NO ENTITY LEVEL TAX EVEN FOR PUBLICLY TRADED REITs**

A C-corporation is taxed on its net income without any reduced tax rate for capital gains. A REIT is a type of pass-through entity that can eliminate its taxable income because, unlike most other corporations, it is permitted to deduct the amount of any dividends it pays when calculating its taxable income. This exemption from an entity level tax is the primary reason that a publicly traded entity desires to qualify as a REIT. Publicly traded entities that are not REITs are often taxed at the entity level (see Practice Notes, Choice of Entity: Tax Issues (http://us.practicallaw.com/1-382-9949) and Taxation of Publicly Traded Partnerships (http://us.practicallaw.com/9-501-0947)).

Unlike a C-corporation, a REIT can use three methods to deal with its capital gain income:

- It can designate dividends it distributes as capital gain dividends to the extent that it has capital gains. This allows individual US stockholders to pay tax on that capital gain dividend at a preferential rate (maximum rate of 15% for dividends that qualify for long-term capital gains treatment).
- It can keep the capital gains and pay an entity level tax on them at a rate of 35%.
- It can elect to designate certain capital gains as undistributed. The REIT and the stockholders pay tax on designated undistributed capital gains but the stockholders get a tax credit for the entity level tax paid on that gain by the REIT.

If a REIT is selling assets, both the first and third methods enable the REIT to keep the after-tax capital resulting from a sale but the third method is generally more beneficial for the stockholders. There is a 4% excise tax imposed on REITs that do not distribute sufficient amounts of income (see 4% Excise Tax on Certain Undistributed Income). However, this excise tax is not imposed on the capital gains dealt with by any of these three methods as long as an actual distribution is made by January of the following year.

Unlike other pass-through entities (such as a partnership or S-corporation), a REIT does not allow the pass-through of losses to its stockholders. In addition unlike other corporations, dividends paid by a REIT are generally not eligible for the lower rates (15% for individuals and effectively 10.5% for corporations) for qualifying dividend income of a US corporate and individual stockholder. For more information about the taxation of dividends paid by a corporation that is not a REIT, see Practice Notes, US Equity Offerings in the US: Tax Consequences for Investors (http://us.practicallaw.com/0-386-3929) and Foreign Equity Offerings in the US: Tax Consequences for Investors (http://us.practicallaw.com/2-386-2325).

**ABILITY TO ATTRACT TAX-EXEMPT AND FOREIGN INVESTORS**

Other benefits of REIT status, as compared to owning real estate in an entity that is a pass-through entity for tax purposes (for example, an entity treated as a partnership for tax purposes), include the ability for:

- Tax-exempt investors to invest in leveraged real estate without incurring the tax on unrelated trade or business income (UBTI). However, there are particular REIT rules for pension fund investors which may cause dividends to be treated as UBTI for the pension plans.
- Foreign investors (including sovereign wealth funds) to invest in US real estate without having to pay a tax on the sale of the indirect interests in the real estate in certain circumstances (see REIT Withholding Issues and Box, Taxation of Foreign Investors in REITs).

One potential negative consequence of electing REIT status is the need to distribute cash (or possibly issue dilutive stock) to comply with the annual REIT distribution requirements (see REIT Distribution Requirements). This could prevent the REIT from accumulating cash that could otherwise be used to make future acquisitions or improvements.

**ORGANIZATIONAL REQUIREMENTS FOR REITs**

A REIT must:

- Be managed by trustees or directors (see Managed by Trustees or Directors).
- Be beneficially owned by 100 or more persons (see Beneficially Owned by 100 or More Persons).
- Issue transferable shares or certificates (see Transferable Shares or Certificates).
- Be taxable as a US corporation (see Taxable as a US Corporation).
- Not be a bank or insurance company (see Not a Bank or Insurance Company).
- Not be more than 50% owned by five or fewer individuals (see More Than 50% Owned by Five or Fewer Individuals).

See IRC Section 856(a).

**MANAGED BY TRUSTEES OR DIRECTORS**

One or more trustees or directors must manage the REIT. This requirement must be satisfied at all times during every REIT taxable year. However, as long as a REIT is formed as a state law trust, corporation or LLC, this requirement is not usually difficult to meet.
**BENEFICIALLY OWNED BY 100 OR MORE PERSONS**

One hundred or more persons must own a REIT. However, this requirement does not apply until after the first taxable year for which a REIT election is made. After the first taxable year, it generally must be met during at least 335 days of each taxable year. For example, an entity that elects to be taxed as a REIT beginning in 2011 satisfies this requirement if it has 100 or more stockholders at all times on and after January 31, 2012.

Ownership for purposes of this requirement is based on actual ownership and not beneficial ownership. Generally, this requirement is not an issue for publicly traded REITs. However, private REITs often engage facilitators to locate 100 investors. The stock sold to these private investors is often a special class of non-voting preferred stock issued under an offering memorandum:

- With an aggregate liquidation preference of $100,000.
- Which earns a fixed return payable semi-annually (generally in the 9% to 12% range).

In many cases, the distribution provisions in the designation of the non-voting preferred stock allows for common dividends to be paid if the preferred is current to the last dividend payment date. Occasionally, the owner of the common stock in a private placement also purchases shares of the non-voting preferred stock to make certain it owns 80% of each class of outstanding stock (this allows the stockholder to contribute appreciated assets to the REIT in a tax-free transaction).

The REIT’s organizational documents almost always contain provisions restricting transfers of stock that would result in a violation of this ownership requirement. Again, this requirement is generally not an issue for publicly traded REITs.

**TRANSFERABLE SHARES OR CERTIFICATES**

The REIT must issue transferable shares or transferable certificates to evidence its beneficial ownership (see IRC § 856(a)(2)). This requirement must be satisfied at all times during every REIT taxable year. However, securities law restrictions, restrictions on transferability of stock issued to employees and restrictions imposed by stockholder level agreements generally should not result in a violation of this requirement.

**TAXABLE AS A US CORPORATION**

The REIT must be taxable as a US corporation. This requirement must be satisfied at all times during every REIT taxable year. If the REIT is formed as a state law entity other than a corporation, this requirement is satisfied if the entity files its US federal income tax return for its first year as a REIT on an IRS Form 1120-REIT. The entity does not need to separately file a “check the box” election to be treated as a corporation for tax purposes. For more information about the check the box rules, see Practice Note, Choice of Entity: Tax Issues (http://us.practicallaw.com/1-382-9949).

**NOT A BANK OR INSURANCE COMPANY**

The REIT must not be a financial institution or an insurance company within the meaning of the IRC Section 816. This requirement must be satisfied at all times during every REIT taxable year. It is unusual for this requirement to present any legal issues.

**NOT MORE THAN 50% OWNED BY FIVE OR FEWER INDIVIDUALS**

Not more than 50% in value of the REIT’s outstanding stock can be owned actually or constructively by five or fewer individuals or certain specified entities (known as the closely held test). This requirement does not apply until after the REIT’s first taxable year and thereafter generally must be satisfied during the last half of each taxable year. This requirement does not restrict ownership by publicly traded, widely held corporations because there generally are not five or fewer individuals or other specified entities who beneficially own more than 50% of the REIT’s stock (treating the stockholders of the public traded entity as if they owned the REIT stock held by the publicly traded corporation). The determination of more than 50% ownership is based on the value of the stock.

If a REIT complies with applicable rules that require it to determine the actual ownership of its stock and the REIT does not know, or would not have known through the exercise of reasonable diligence, that it failed to meet the limitation on ownership by five or fewer individuals, the REIT is treated as having met this requirement. To comply with these rules, the REIT must demand annual written statements from the record holders of significant percentages of its capital stock asking them to disclose the shares’ beneficial owners (meaning, the persons required to include in gross income the dividends paid by the REIT). Failure by the REIT to comply with these record keeping requirements could subject the REIT to monetary penalties.

A REIT’s corporate organizational documents generally provide for restrictions regarding ownership and transfer of REIT shares to assist the REIT in continuing to satisfy these ownership requirements. These provisions often provide that transfers that result in ownership above a defined percentage (known as the ownership limit) of the REIT’s stock will be null and void, and that any dividends paid to a stockholder holding shares in violation of the restrictions are deemed earned on behalf of a named charity. The ownership limit may be determined by class of stock or by value of all classes of stock held by a particular holder. Because the ownership limit is generally defined by beneficial or constructive ownership (meaning, looking through a corporation or partnership to determine whether any individual owns economic interests the REIT shares by virtue of their ownership interest in the corporation or partnership), a transfer of the interests in an entity that is an indirect owner of the REIT can violate the ownership limit.

In the context of a private REIT, particularly one with significant institutional or publicly traded investors, there is often negotiation regarding the contractual provisions limiting indirect transfers.
of interests in the REIT. The ownership limit provisions in the
organizational documents often restrict ownership beyond what
is required for the REIT to maintain its REIT status. The REIT
uses these provisions to monitor its ownership. The organizational
documents generally permit the REIT to waive the ownership limit
if it determines that an acquisition will not result in a violation
of the REIT rules. In connection with the waiver, the REIT often
requires the potential purchaser to make various representations
regarding its ownership of the REIT stock and the concentration
of the ownership in the purchaser. Points that are often negotiated
for this waiver letter include:

- How often must the purchaser update the representations.
- What actions must the purchaser take to confirm the continued
  accuracy of the representations.

**REIT INCOME TESTS**

A REIT must annually satisfy two income tests:

- 75% gross income test (see 75% Gross Income Test: Must Be
  Real Estate Related).
- 95% gross income test (see 95% Gross Income Test: Must Be
  Passive Income).

**75% GROSS INCOME TEST: MUST BE REAL ESTATE RELATED**

75% of the REIT’s annual gross income must be real estate
related (known as the 75% gross income test) (see IRC § 856(c)
(3)). For purposes of this test, six categories of income items
generally are treated as real estate related:

- Rents from real property (see Rents from Real Property).
- Real property gains (see Real Property Gains).
- Dividends and gains from other REITs (see Dividends and
  Gains from Other REITs).
- Interest on real estate (see Interest on Real Estate).
- Income from foreclosure property (see Income from
  Foreclosure Property).
- Income from temporary investments (see Income from
  Temporary Investments).

**Rents from Real Property**

The first category of good income is rents from real property. For
many REITs, this is the primary source of qualifying income.

The amount of rent from real property must not be based in any
way on the income or profits of any person but may be based on a
fixed percentage or percentages of receipts or sales.

The rents also must not be “related party rents.” Related party rents
are rents received from a tenant if an actual or constructive owner
of 10% or more of a REIT’s capital stock actually or constructively
owns 10% or more of the interests in the tenant (see IRC § 856(d)
(2)(B)). Ownership is measured by capital or profits interest in the
tenant if the tenant is a partnership or LLC or by voting power or
value of all classes of stock if the tenant is a corporation.

However, rent received from a taxable REIT subsidiary (TRS) is
not treated as related party rent if at least 90% of the space at the
property to which the rents relate is leased to third parties and the
rents paid by the TRS are substantially comparable to rents paid by
the REIT’s other tenants for comparable space (see IRC § 856(d)
(B)(A)(i)). There is an additional exception to the related party rent
prohibition for hotel and health care REITs (see IRC § 856(d)(B)
(B)). A TRS includes a corporation other than a REIT that is:

- A direct or indirect subsidiary of a REIT and that has made a
  joint election with the REIT to be treated as a TRS.
- A subsidiary of a TRS if the TRS owns securities possessing
  more than 35% of the total voting power or value of the
  outstanding securities of that corporation.

Whether rents paid by a TRS are substantially comparable to rents
paid by other tenants is determined at the time the lease with
the TRS is entered into, extended and modified (if a modification
increases the rents due under the lease). For more information
about TRSs, see *Use of Qualified REIT Subsidiaries and Taxable REIT Subsidiaries*.

However, if a lease with a controlled taxable REIT subsidiary
(CTRS) is modified and the modification increases the rents
payable by the CTRS, any increase does not qualify as rents from
real property. For purposes of this rule, a CTRS is a TRS in which
a REIT owns stock possessing more than 50% of the voting power
or more than 50% of the total value of the outstanding stock of the
CTRS (see IRC § 856(d)(B)(A)(iv)).

It can be helpful to provide significant investors in a REIT with
a list of the tenants at the property whose rent exceeds more
than 5% of the gross income of the REIT and would impact
REIT status if those rents were treated as related party rents.
This issue is often discussed in the context of a non-publicly
traded entity that owns a single property or a small portfolio of
properties and is electing REIT status to accommodate either
foreign or tax-exempt investors.

Rent attributable to personal property leased in connection with
a lease of real property is treated as rent from real property if
the amount of rent attributable to the personal property is not
greater than 15% of the total rent received under the lease.
Rent is allocated between a REIT’s real property and personal
property based on the relative fair market values of the properties.
If this condition is not met, the portion of the rent attributable to
personal property does not qualify as rents from real property.

For rent received from REIT tenants to qualify as good income for
purposes of the REIT income tests, there are limits on the types
of services that the REIT can provide to its tenants. The REIT can
only perform services that are usually or customarily rendered in
connection with the rental of space for occupancy. Examples of
permitted services include the provision of light, heat, or other
utilities, trash removal and general maintenance of common
areas. In addition, a REIT may employ an independent contractor
(from whom the REIT derives no revenue) to provide customary
services or a TRS, which may be wholly or partially owned, to
provide both customary and non-customary services to a REIT’s tenants and still have the rent received from those tenants qualify as good income for purposes of the REIT income tests.

Real Property Gains
The second category of good income is gain from the sale or other disposition of real property (unless held as inventory).

Dividends and Gains from Other REITs
The third category of good income is dividends and other distributions on, and gain from the sale or other disposition of, transferable units or certificates of beneficial ownership in other REITs (unless held as inventory).

Interest on Real Estate
The fourth category of good income is interest on obligations secured by mortgages on real property or on interests in real property (including certain qualified mezzanine financings indirectly secured by interests in real property).

For this purpose, interest generally does not include any amount received or accrued, directly or indirectly, if the determination of all or some of the amount depends in any way on the income or profits of any person. However, an amount of interest received or accrued generally is not excluded from the term interest solely because it is based on a fixed percentage or percentages of receipts or sales.

Income from Foreclosure Property
The fifth category of good income is income and gain derived from foreclosure property.

Income from Temporary Investments
The sixth and final category of good income is income from certain types of temporary investments. This provision recognizes the practical difficulties of identifying and purchasing real estate immediately after the receipt of new capital. Therefore, it allows a REIT to receive good income from stock or debt instruments attributable to the temporary investment of new capital for one year from the date the REIT receives the capital.

95% GROSS INCOME TEST: MUST BE PASSIVE INCOME
95% of the REIT’s annual gross income must be passive income (known as the 95% gross income test) (see IRC § 856(c)(2)). Passive income for purposes of the 95% gross income test generally includes the six categories of income items treated as real estate related (see 75% Gross Income Test: Must Be Real Estate Related) plus:

- Dividends (see IRC § 856(c)(2)(A)).
- Interest that would otherwise qualify under the 75% gross income test except that it is not secured by real estate (see IRC § 856(c)(2)(B)).

SPECIAL RULES THAT APPLY TO REIT INCOME TESTS
In applying the 75% and 95% gross income tests, a REIT is treated as directly earning the income of a qualified REIT subsidiary (QRS) and its proportionate share of the income of an entity treated as a partnership for tax purposes. Each item of gross income retains the same character in the hands of the REIT as it has when earned by the QRS or entity treated as a partnership for tax purposes. A QRS is a wholly-owned subsidiary that is not a TRS. A QRS is treated as a branch or division of the REIT for tax purposes. For more information about QRSs and TRSs, see Use of Qualified REIT Subsidiaries and Taxable REIT Subsidiaries. For more information about entities treated as partnerships for tax purposes, see Special Rules for REITs Owning Partnership and LLC Interests.

HEDGING TRANSACTION INCOME EXEMPT FROM REIT INCOME TESTS
A REIT may occasionally enter into hedging transactions. For these purposes, a hedging transaction generally is any transaction a REIT enters into in the normal course of its business primarily to manage risk of either:

- Interest rate changes or fluctuations with respect to borrowings made or to be made to acquire or carry real estate assets.
- Currency fluctuations with respect to an item of qualifying income under the 75% or 95% gross income test.

A REIT’s hedging activities can include entering into interest rate swaps, caps, floors, options to purchase these items, and futures and forward contracts. Income from a hedging transaction (including gain from the sale or disposition of a hedge that is clearly identified as a hedging transaction) is not treated as gross income and is exempt from the 75% and 95% gross income tests (see IRC § 856(c)(5)(G)).

The hedge must be properly identified on the day it is entered into. If a REIT does not properly identify a transaction as a hedge, the income from the hedging transactions is not likely to be treated as exempt from the 75% and 95% gross income tests.

SPECIAL CATEGORIES OF INCOME FOR REIT INCOME TESTS
There are special rules for the following four categories of income:

- Prohibited transaction income (see Prohibited Transaction Income).
- Cancellation of indebtedness income (CODI) (see CODI).
- Foreign currency gain or loss (see Foreign Currency Gain or Loss).
- Certain fee income (see Certain Fee Income).

Prohibited Transaction Income
Any gain that a REIT realizes (including any net foreign currency gain recognized after July 30, 2008) on the sale of property held as inventory or otherwise held primarily for sale to customers in the ordinary course of the REIT’s business (including a REIT’s share
of any gain realized directly or indirectly by a REIT’s operating partnership) is treated as income from a prohibited transaction and subject to a 100% penalty tax unless certain safe harbor exceptions apply (see IRC § 857(b)(6)(A)). Whether property is held as inventory or primarily for sale to customers in the ordinary course of the REIT’s trade or business is a question of fact that depends on all the facts and circumstances surrounding the particular transaction.

One of the more important safe harbors is for limited sales of inventory held at least two years and meeting certain additional requirements (see IRC § 857(b)(6)(C)).

An additional exception exists for inventory that is foreclosure property. A REIT recognizes income on net income from foreclosure property (defined in IRC § 857(b)(4)(B)) at the top corporate tax rate only to the extent that it is not classified as good income for the purposes of the 75% gross income test.

Prohibited transaction income can also adversely affect a REIT’s ability to satisfy the 75% and 95% gross income tests (see REIT Income Tests).

CODI

If a REIT owns distressed property and can negotiate a reduction in the amount of debt securing the property, the REIT is required to recognize CODI. CODI is ignored for purposes of the 75% and 95% gross income tests. It also will not cause a REIT to fail the 90% distribution requirement (see IRC § 857(e) and REIT Distribution Requirements). However, if the REIT does not distribute the CODI, it will have to pay tax on that income.

If a REIT modifies distressed mortgages to prevent default or purchases distressed mortgages subject to modification, Revenue Procedure 2011-16 provides a safe harbor that prevents income from the modified loan from being classified as prohibited transaction income (see Prohibited Transaction Income).

Foreign Currency Gain or Loss

For purposes of the 75% and 95% gross income tests, foreign currency gain is excluded if the income is attributable to:

- Real estate assets.
- Becoming an obligor on a mortgage (in the case of the 75% gross income test).
- Passive assets or obligations (in the case of the 95% gross income test).

See IRC Section 856(n).

However, except for income from hedging transactions, foreign currency gain that results from dealing or engaging in substantial and regular trading in securities is included in the calculation of both the 75% and the 95% gross income tests.

Certain Fee Income

In certain circumstances, a REIT can receive fees for property management, brokerage and leasing services that it provides for properties that is does not entirely own. These fees do not qualify under the 75% or 95% gross income test for the portion of the properties not owned, directly or indirectly, by the REIT.

Reit Asset Tests

At the close of each quarter of a REIT’s taxable year, a REIT must also satisfy the following four tests relating to the nature and diversification of its assets:

- **Test one.** At least 75% of the value of a REIT’s total assets must be represented by “real estate assets,” cash, cash items and government securities (known as the 75% asset test) (see IRC § 856(c)(3)). For purposes of this test, the term real estate assets generally includes:
  - real property (including interests in real property, interests in mortgages on real property and certain qualified mezzanine financings secured by interests in real property);
  - shares (or transferable certificates of beneficial interest) in other REITs; and
  - any stock or debt instrument attributable to the investment of the proceeds of a stock offering or a public offering of debt with a term of at least five years but only for the one-year period beginning on the date the REIT receives the proceeds.

- **Test two.** Not more than 25% of the value of a REIT’s total assets can be represented by securities, other than securities includable in the 75% asset test (see IRC § 856(c)(4)(A)).

- **Test three.** Except for investments in other REITs and a REIT’s QRSs and TRSs:
  - the value of any one issuer’s securities may not exceed 5% of the value of a REIT’s total assets (known as the 5% asset test) (see IRC § 856(c)(4)(B)(iii)(I)); and
  - a REIT may not own more than 10% of the total vote or value of the outstanding securities of any one issuer (known as the 10% asset test) (see IRC § 856(c)(4)(B)(iii)(III)). Solely for purposes of the 10% asset test, the determination of a REIT’s interest in the assets of a partnership or LLC in which a REIT owns an interest is generally based on the REIT’s proportionate interest in any securities issued by the partnership or LLC.

- **Test four.** Not more than 25% of the value of a REIT’s total assets can be represented by the securities of one or more TRS (see IRC § 856(c)(4)(B)(ii)).

Special Rules that Apply to Reit Asset Tests

If a REIT meets the asset tests at the close of any quarter, it will not later lose its status as a REIT for failure to satisfy one the asset tests at the end of a later quarter solely because of changes in asset values. If a REIT fails to satisfy one of the asset tests because it acquires securities or other property during a quarter, the REIT can cure this failure by disposing of sufficient bad assets within 30 days after the close of that quarter.
For purposes of the asset tests, the term “securities” generally does not include:

- Units in another REIT.
- Equity or debt securities of a QRS or TRS.
- Mortgage loans that are treated as real estate assets.
- Equity interests in a partnership.

See IRC Section 856(m).

**REIT DISTRIBUTION REQUIREMENTS**

A REIT must annually distribute dividends (other than capital gain dividends) to its stockholders in an amount at least equal to the sum of:

- 90% of its “REIT taxable income.”
- 90% of its after-tax net income, if any, from foreclosure property.

minus the excess of the sum of certain items of non-cash income over 5% of its REIT taxable income (known as the 90% distribution requirement) (see IRC § 857(a)(1)).

REIT taxable income is calculated in the same manner as the income from an ordinary C-corporation, but without the benefit of the dividends received deduction and without adjustments due to any change in accounting period. A REIT is subject to tax at ordinary corporate tax rates to the extent its taxable income is not distributed. For purposes of the REIT distribution requirement, REIT taxable income is computed without regard to the dividends paid deduction and the REIT’s net capital gain. In addition, for purposes of this requirement, non-cash income means income attributable to:

- Leveled stepped rents. Leveled stepped rents are variable rents that have been “leveled” by IRC Section 467, which prevents certain tax deferral arrangements through variable-rent leases.
- Original issue discount on purchase money debt.
- CODI.
- A like-kind exchange that is later determined to be taxable.

For various reasons, a like-kind exchange (for example, an exchange of real estate items under IRC Section 1031), can later be deemed to be taxable by the IRS due to a failure to satisfy the requirements for tax-free treatment.

A REIT generally must pay the dividends described above in the taxable year to which they relate. At a REIT’s election, a dividend distribution is treated as paid in a taxable year if it is:

- Declared before the REIT timely files its tax return for that year.
- Paid on or before the first regular dividend payment after the declaration as long as the payment is made during the 12-month period following the close of that year.

These annual distributions are taxable to a REIT’s stockholders (other than tax exempt entities, in the year in which paid) even if the distributions relate to the prior year for purposes of the 90% distribution requirement.

The amount distributed must not be preferential (meaning, every stockholder of the class of stock to which a distribution is made must be treated the same as every other stockholder of that class and no class of stock can be treated other than according to its dividend rights as a class).

To the extent that a REIT does not distribute all of its net capital gain, or distributes at least 90%, but less than 100% of its REIT taxable income, a REIT must pay tax on the undistributed amount at regular corporate tax rates. Under some circumstances, a REIT may be able to rectify an inadvertent failure to meet the 90% distribution requirement for a year by paying deficiency dividends to its stockholders in a later year.

**4% EXCISE TAX ON CERTAIN UNDISTRIBUTED INCOME**

If the REIT fails to distribute 85% of its ordinary income and 95% of its capital gain income during any year, there is a 4% excise tax on the shortfalls (see IRC § 4981). In each following year, if less than 100% of the ordinary income and capital gain from prior years remains undistributed, the 4% excise tax applies to that shortfall and any new shortfall.

Distributions during a year for excise tax purposes include dividends declared during October, November or December and paid during January of the following year (see IRC § 857(b)(9)).

**USE OF QUALIFIED REIT SUBSIDIARIES AND TAXABLE REIT SUBSIDIARIES**

A qualified REIT subsidiary (QRS) is a wholly-owned subsidiary of a REIT. A QRS can be used to insulate certain assets from specified liabilities, and can be used to issue finance securities.

Taxable REIT subsidiaries (TRSs) were created to solve practical problems created by a business need to provide certain services to tenants beyond the customary tenant services in the local market. Historically, most REITs relied on independent contractors to provide many tenant services. These independent contractors were limited by their inability to provide non-customary services and by the strict prohibition on a REIT deriving any income from the independent contractor. In response to these limitations, the Tax Relief Extension Act of 1999 (TREA) introduced the TRS as a way for a REIT to provide tenant services on a taxable basis.

**QRSs**

A REIT can own and operate certain properties through wholly-owned subsidiaries that the REIT intends to treat as a QRS for tax purposes. A corporation qualifies as a QRS if a REIT:

- Owns 100% of the corporation’s outstanding stock.
- Does not elect with the subsidiary to treat it as a taxable REIT subsidiary (TRS).

See IRC Section 856(i)(2).

Any corporation that a REIT wholly owns (other than a TRS) is treated as a QRS and ignored for tax purposes. Therefore, all
assets, liabilities and items of income, gain, loss, deduction and credit of a QRS are treated as the parent REIT’s assets, liabilities and items of income, gain, loss, deduction and credit. A QRS is not required to pay US federal income tax. A REIT’s ownership of the stock of a QRS does not violate the restrictions on ownership of securities (see REIT Asset Tests). A QRS can be used by a mortgage REIT to issue structured finance securities. However, a REIT generally cannot use a real estate mortgage investment conduit (a REMIC) for this purpose because the REMIC would be treated as selling the REMIC’s regular interests in prohibited transactions (see Prohibited Transaction Income). A REMIC is a passive vehicle that holds mortgages, certain pass-through interests in mortgages or certain REMIC interests and that is created under IRC Sections 860A to 860G. Unlike a mortgage REIT, a REMIC is required to have a fixed pool of assets.

**TRSs**

A TRS includes a corporation other than a REIT that is:

- A direct or indirect subsidiary of a REIT and that has made a joint election with the REIT to be treated as a TRS.
- A subsidiary of a TRS if the TRS owns securities possessing more than 35% of the total voting power or value of the outstanding securities of that corporation.

A TRS is subject to income tax as a regular C-corporation.

Other than some activities relating to lodging and health care facilities (see Box, Hotel and Health Care REITs), a TRS generally can engage in any business, including the provision of customary or non-customary services to tenants of its parent REIT. A REIT’s ownership of securities of a TRS is not subject to the 5% or 10% asset test (see REIT Asset Tests).

Special rules may apply if a TRS is considered a CTRS (see Rents from Real Property). A CTRS is a TRS in which a REIT owns stock possessing more than 50% of the voting power or more than 50% of the total value of the outstanding stock of the CTRS (see IRC § 856(d)(8)(A)(iv)).

**Bad Fees for Services by TRSs**

A REIT’s TRS can provide services to a REIT’s tenants for a fee. However, these fees may not qualify under the 75% or 95% gross income test for the portion of the properties not owned, directly or indirectly, by the REIT (see Certain Fee Income). These determinations are inherently factual and the IRS has broad discretion to assert that amounts paid between a REIT’s related parties should be reallocated to reflect their respective incomes. If the IRS successfully makes this type of assertion, a REIT is required to pay a 100% penalty tax on the excess of an arm’s-length fee for tenant services over the amount actually paid (see IRC § 856(d)(8)).

**100% Penalty Tax and TRSs**

Any redetermined rents, redetermined deductions or excess interest a REIT generates is subject to a 100% penalty tax. In general, redetermined rents are rents from real property that are overstated as a result of any services provided to any of a REIT’s tenants by one of a REIT’s TRSs. Redetermined deductions and excess interest represent any amounts that are deducted by a TRS for amounts paid that are in excess of the amounts that would have been deducted based on arm’s-length negotiations.

**UPREIT STRUCTURES**

In an umbrella partnership REIT (UPREIT) structure, a partnership structure enables persons owning real estate to contribute the real estate to a REIT operation without being subject to current tax on any appreciation in the real estate. In this structure, a partnership holds both the old assets of the REIT and any property contributed by a new participant. The new participant acquires a partnership interest in exchange for the real estate. If properly structured, the contribution of real estate is not be subject to tax until the partner exchanges his partnership interest for REIT stock.

A typical UPREIT structure is shown in the diagram below:

**SPECIAL RULES FOR REITs OWNING PARTNERSHIP AND LLC INTERESTS**

If a REIT is a partner in a partnership or a member in a LLC treated as a partnership for tax purposes, the REIT is deemed to own its proportionate share of the assets of the partnership or LLC based on its interest in partnership or LLC capital. The determination of ownership is also subject to special rules relating to the 10% asset test (see REIT Asset Tests). In addition, the REIT is deemed to be entitled to its proportionate share of the income of that entity. For purposes satisfying the REIT income and asset tests (see REIT Income Tests and REIT Asset Tests), the assets and gross income of the partnership or LLC retain the same character in the hands of the REIT as in the partnership or LLC.

If a REIT owns an interest in partnership or LLC that takes or expects to take actions that could jeopardize a REIT’s status as a
REIT or require the payment of a tax, the REIT may be forced to dispose of its interest in that entity.

In addition, it is possible that a partnership or LLC could take an action which could cause the REIT to fail a REIT income or asset test and that a REIT would not become aware of that action in time to dispose of a REIT's interest in that entity (or take other corrective action on a timely basis). In that case, a REIT could fail to qualify as a REIT unless the REIT is entitled to relief for reasonable cause.

**REIT SPIN-OFFS & MERGERS**

**SPIN-OFFS**

A parent (non-REIT) entity that owns a corporate subsidiary that could qualify as a REIT can distribute or spin-off the subsidiary stock to its stockholders. After the distribution or spin-off, the subsidiary can elect to be taxed as a REIT.

For the spin-off to qualify as a tax-free transaction, it must satisfy the general rules relating to tax-free spin-offs including the:

- Active business requirement (meaning that both parent and subsidiary are engaged in an active trade or business before and after the spin-off).
- Business purposes requirement (meaning that there is an independent business reason for the spin-off transaction).

For more information about spin-offs including the requirements for a tax-free transaction, see *Practice Note, Spin-offs: Overview* ([http://us.practicallaw.com/2-503-1986](http://us.practicallaw.com/2-503-1986)).

It is important to note that even if the spin-off would otherwise qualify as a tax-free transaction, the subsidiary must disgorge any earnings and profits from its pre-REIT years to qualify as a REIT after a spin-off. In addition, the new REIT continues to be subject to a corporate level tax on the excess of the value of its assets over their tax basis (known as built-in gain assets) if sold within ten years of the REIT election.

A REIT may also spin-off a subsidiary to its stockholders in a tax-free transaction if the general spin-off requirements described above are satisfied. But, if the parent was always a REIT, there is less incentive to qualify the spin-off as tax-free because the parent REIT generally is not subject to tax on any gain recognized in the spin-off.

**MERGERS**

A REIT can merge with another REIT in either a tax-free or taxable merger. If the consideration paid in the merger is solely common stock of the acquiring REIT, the merger generally qualifies as a tax-free merger. Therefore, the target REIT and its stockholders generally do not recognize any taxable gain or loss.

If the consideration in the merger is a combination of acquiror stock and cash, a merger can still be structured as tax-free if a substantial portion of the consideration (generally at least 35% to 40%) is payable in stock. In this case, the stockholders recognize gain only to the extent of the cash consideration. If the portion of the stock received does not qualify as substantial for this purpose (less than 35% to 40%), the merger generally is a taxable transaction. As a result, the stockholders recognize gain based on the amount of cash and the value of the acquiror stock received.

The most common forms of REIT mergers are:

- **Merger of target REIT into acquiring REIT.** The merger generally is either taxable or tax-free depending on the amount of the cash consideration as described above. Since the target does not survive, it is likely that approval for the transaction is required to maintain the target's contractual relationships and regulatory licenses.

- **Merger of target REIT into wholly-owned subsidiary of acquiring REIT.** The merger generally is either taxable or tax-free depending on the amount of the cash consideration as described above. In this case, approval for the transaction is also likely required to maintain the target's contractual relationships and regulatory licenses (since the target survives in the merger).

- **Merger of REITs that are in the UPREIT format.** For the merger to qualify as tax-free, it generally must be completed in two steps, as a merger of the REITs and a combination of the operating partnerships. The manner in which the operating partnerships are combined depends in significant part on whether any unit holders object to the merger and the provisions of the operating partnership agreement governing the approval procedures for mergers or asset sales. There may be unit holders of the target operating partnership who acquired their units in exchange for a contribution of property. Contribution agreements often contain tax protection provisions that trigger certain rights if the operating partnership disposes of the contributed property within a defined period of time. It is important to review the contribution agreement and any tax protection agreements to determine if the merger triggers any of the unit holders’ rights.


**REIT WITHHOLDING ISSUES**

A REIT must consider US tax withholding when it holds REMIC residuals or a subsidiary is a taxable mortgage pool (TMP) (see IRS Notice 2006-97). The REIT must pay tax for any excess inclusions...
attributable to the REMIC residuals or TMP attributable to a stockholder that is a disqualified organization (for example, a state government). A REIT must also must withhold on excess inclusions attributable to any foreign stockholders. Also, for other stockholders, it must report to them the amount of their share of the excess inclusions.

US withholding issues come up in other contexts. For example, a mortgage REIT or a REIT holding mostly foreign assets generally is not a US real property holding corporation (a USRPHC). As a result, dividends the REIT pays to foreign stockholders are subject to the normal US withholding tax rates (30% withholding unless reduced by an applicable income tax treaty). However, capital gain dividends paid to foreign stockholders are not subject to US withholding tax.

In certain cases, a REIT can be treated as a USRPHC. If a REIT is a USRPHC, all non-dividend distributions to a foreign stockholder that are not attributable to a sale of US real estate are subject to a 10% US withholding tax (see IRC § 1445(e)(3)). However, if a distribution is attributable to a sale of US real estate, the gain may be subject to US withholding tax at the maximum tax rates (currently 35% for corporations with lower rates for individuals) (see IRS Notice 2007-55). A dividend distribution from a REIT that is a USRPHC is subject to the normal US withholding tax rules (30% withholding unless reduced by an applicable income tax treaty), unless the dividend is attributable to a sale of US real estate assets. If the dividend is attributable to a sale of US real estate assets, the gain may be subject to US withholding tax at the maximum tax rates described above.

There is no US withholding requirements for a buyer of publicly traded USRPHC stock from a foreign seller (see IRC § 1445(b)(6)). If the USRPHC stock is not publicly traded, the buyer generally must withhold 10% of the sale price that would otherwise be paid to a foreign seller. It is important to note that a “domestically controlled” REIT is not treated as a USRPHC (see IRC § 897(h)(1)). Domestically controlled means more than 50% of the value of the REITs stock is owned by US persons that are not pass-through entities for foreign holders.

For certain other US tax issues for foreign stockholders, see Box, Taxation of Foreign Investors in REITs.

**TAXATION OF FOREIGN INVESTORS IN REITs**

There are some other unique US tax issues for foreign investors that are worth mentioning beyond those discussed above in **REIT Withholding Issues**.

A sale of stock by a foreign stockholder is not subject to US tax if a REIT is domestically controlled (see IRC § 897(h)(1)). In addition, there is no US tax if the REIT stock is publicly traded and the foreign stockholder owned less than 5% at all times during the previous 12 months (see IRC § 897(h)(1)). This rule is more favorable than the rule applicable to non-REITs (for no US tax in that case, the holder must have held less than 5% for five years).

An additional branch profits tax of 30%, which normally applies to a sale by a foreign corporation of US real estate, does not apply on the sale of a REIT stock. However, the branch profits tax may apply to a corporate stockholder that receives a dividend from a REIT that is attributable to a sale by the REIT of actual US real estate.

**HOTEL AND HEALTH CARE REITs**

TRSs cannot directly run hotel and health care facilities. In addition, hotels and health care facilities cannot even be leased to a TRS (and the TRS cannot supply the rights to use its franchise name to another person) unless the facility is managed by an eligible independent contractor (see IRC §§ 856(d)(8)(B) and 856(l)(3)). Generally, a REIT gets exposure to hotel or healthcare facilities by owning the hotel or healthcare facility and leasing it to its TRS which hires an eligible independent contractor to manage the facility. An eligible independent contractor for a TRS that is leasing a lodging facility or a health care facility from a REIT is an independent contractor that is actively engaged in the business of managing lodging facilities or health care properties, respectively, for unrelated persons (see IRC § 856(d)(9)).

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