REITs: Use in Commercial Real Estate Transactions

A Practical Guidance® Practice Note by
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This practice note discusses using real estate investment trusts (REITs) for commercial real estate purposes, including formation of REITs, types of REITs, IRS requirements, and sale-leaseback transactions, as well as practical and strategic considerations for investors, sponsors, tenants, and landlords.

For more information on REIT formation and requirements for maintaining REIT status, see Real Estate Investment Trusts, REIT Organization, REIT Tax Considerations, and REIT Test Failures and Remedies.

Types of REITs

A REIT is a legal entity formed for the purpose of investing in commercial real estate. REITs raise capital by issuing shares of stock (or other beneficial interests) to investors and utilize the capital to build a portfolio of long-term real estate investments. By investing in a REIT, investors are able to own a share of diversified portfolio of large commercial real estate projects (such as shopping malls, hospitals, storage facilities, timberland, or other commercial enterprises) without the responsibilities and obligations of owning real estate directly. In essence, REITs are like mutual funds for real estate. A REIT consists of a diversified portfolio of real estate much in the same way that a mutual fund consists of a diversified portfolio of securities.

REITs have substantial tax advantages. Unlike corporations taxed as C corporations, REITs can generally avoid federal taxes at the entity level. Most public companies are organized as C corporations which pay federal income tax at the entity level. Once the C corporation distributes dividends to its shareholders, the shareholders must then pay tax on the dividends (thus the profits of the enterprise are taxed twice). In contrast, REIT investors are only taxed when dividends are distributed, leading to significant tax savings.

There are three main types of REITs:

- Publicly traded REITs
- Public, non-traded REITs –and–
- Private REITs

Publicly traded REITs are registered with the Securities and Exchange Commission (SEC) and listed on a stock exchange such as the New York Stock Exchange. Public, non-traded REITs are registered with the SEC (meaning there is public information available about the REIT), but shares of the REIT are not actively traded on any national stock exchange. Because they are not listed on an exchange, investors in non-traded REITs have limited liquidity and are generally only able to liquidate their investment in accordance with the REIT's governance documents. Finally, private REITs are not registered with the SEC and not traded on any exchange. There is no public information available about private REITs and they are typically only available to accredited investors, or high net worth individuals.

REITs can generally be classified as either an "equity REIT" or a "mortgage REIT." An equity REIT directly owns real estate and generally invests in a specific asset class such as hotels, apartments, office buildings, industrial buildings, healthcare facilities, data centers, storage facilities, timberland, or a diversified mix of properties. A mortgage REIT either makes mortgage loans or invests in mortgage loans or mortgage-backed securities.

REIT Requirements

REITs can be formed as a corporation, partnership, limited liability company, or business trust in any state in the United States where REITs are permitted. Choosing the entity type and state of formation generally requires the same analysis as with any other business organization. Maryland was the first state to enact REIT statutes and has large body of law surrounding REITs that are very REIT-friendly. For example, Maryland provides broad liability protections and maximizes the enforceability of share transfer restrictions for REITs. Accordingly, many REITs are formed under Maryland law. Most publicly traded REITs are formed as either corporations or business trusts.

Organizational Requirements

Regardless of the state law entity type, for federal tax purposes REITs are treated as corporations. In addition, REITs must meet certain organizational requirements under the Internal Revenue Code. Pursuant to 26 U.S.C. § 856(a), REITs:

- Must be managed by one or more trustees or directors
- Must have transferable shares (or transferable certificates of beneficial interests)
- Must be taxable as a U.S. corporation
- Must not be a bank or insurance company
- Must have at least 100 owners
- May not be a closely held corporation in which 50% or more of the stock is owned by five or fewer individuals –and–
- Must meet certain asset and income tests as described below

For more information on the organizational requirements of a REIT, see REIT Organization and REIT Test Failures and Remedies.

Income Test

The primary purpose of a REIT is to invest in passive real estate activities. To ensure that a REIT's activities are primarily real estate related, a REIT's annual gross income for federal income tax purposes must meet the following two tests.

The 75% Test

26 U.S.C. § 856(c)(3) generally provides that at least 75% of a REIT's annual gross income (excluding gross income from prohibited transactions) must be derived from:

- Rents from real property
- Mortgage interest
- Gain from the sale of real property
- Dividends and gain from other REITs
- Property tax refunds or abatements
- Income from foreclosure
- Amounts received as consideration for entering into a purchase or lease of real property or for making a mortgage loan –and–
- Qualified temporary investment income

The 95% Test

26 U.S.C. § 856(c)(2) generally provides that at least 95% of a REIT's annual gross income must be passive. Accordingly, for purposes of the 95% test, annual gross income must be derived from any of the categories listed above, plus two additional categories: dividends and interest (even if the dividends or interest are not derived from real estate).

One key aspect of the income test is ensuring that the REIT's income qualifies as "rents from real property." If any portion of the rent is based on a percentage of the tenant's cash flow or net income, it can taint the REIT's income for purposes of the income test. Even rent that indirectly flows to the REIT from a sublease may be problematic for a REIT.

Further, a REIT must be careful not to receive impermissible tenant service revenue. A REIT can be deemed to receive this type of income if it provides certain services to a tenant which are not customarily provided in connection with the rental of real property.

REITs must carefully track their sources income and structure investments to ensure that these tests are met. Failing these tests could cause the REIT to lose its REIT status for tax purposes.

For more information on the organizational requirements of a REIT, see REIT Organization and REIT Test Failures and Remedies.

Asset Test

To further ensure a REIT's activities are real estate related, REITs must meet a quarterly asset test. To satisfy the test, the REIT must meet the following conditions:

- At least 75% of its assets must be real estate assets, cash, and governmental securities.

- Not more than 25% of its assets can consist of securities (except for securities which are permitted above).
- Not more than 20% of its assets can consist securities in a taxable REIT subsidiary (a TRS).
- Not more than 20% of its assets can consist of nonqualified publicly offered REIT debt instruments.
- Except for securities in a TRS or securities included under the first bullet, (1) not more than 5% of a REIT's assets can consist of securities of a single entity, (2) a REIT cannot own more than 10% of the voting power of any one entity, and (3) a REIT cannot own more than 10% of the outstanding securities of any entity.

For more information on the organizational requirements of a REIT, see REIT Organization and REIT Test Failures and Remedies.

Distributions

Another key REIT requirement is that dividends must be distributed to the REIT's owners on an annual basis. The amount of the dividend must be equal to the sum of (1) 90% of its "REIT taxable income" and (2) 90% of after-tax net income from foreclosure property, minus the excess of certain items of noncash income over 5% of its REIT taxable income (see 26 U.S.C. § 857(a)(1)).

If a REIT fails to satisfy the 90% distribution requirement, then the REIT is subject to an excise tax. If a REIT satisfies the 90% distribution requirement but distributes less than 100% of its taxable income in a taxable year, it will be subject to tax at ordinary corporate rates on its retained taxable income. For this reason, most REITs distribute 100% of their taxable income.

Other REIT Structure Considerations

Taxable REIT Subsidiaries (TRSs)

One method REITs can use to creatively structure their investments to meet the REIT requirements is a TRS. A TRS is a direct or indirect subsidiary of the REIT that is C corporation and files an election with the IRS to be treated as a TRS. A TRS is treated as a separate corporation and is not consolidated with the REIT for income and asset testing or any other federal tax purposes. Accordingly, the REIT is not deemed to receive its proportionate share of the income of, or to own its proportionate share of the assets of, a TRS.

Because a TRS is excluded from the REIT's income and asset tests, it is able to undertake activities that go beyond purely real estate activities. TRSs can generally engage in any business, subject to some limited restrictions. For example, a TRS may not directly or indirectly operate or manage a lodging facility or a healthcare facility or provide certain rights related to lodging facilities or healthcare facilities. Typically, the TRS must engage an "eligible independent contractor" to operate those types of facilities. The drawback to using a TRS structure is that the TRS does not get the tax benefits of being a REIT and is subject to federal corporate income tax on its taxable income.

REITs can utilize a TRS in situations in which it may be problematic for the REIT to meet the asset or income tests. For example, a TRS can provide non-customary services to a tenant and receive income other than "rents from real property" without violating the income test.

However, dealings between a REIT and its TRS must be at arm's length. In particular, a TRS must be compensated at arm's-length pricing for services it performs to the REIT's tenants, and loans to a TRS must not bear excessive interest. If a TRS undercharges for services it performs to the REIT or its tenants or if it is charged excessive interest, a 100% excise tax applies to the difference between the amount charged and the arm's-length amount. With respect to services, however, the 100% excise tax will not apply, among other exceptions, if the TRS is compensated at 150% or more of its cost for providing the service.

REITs may also utilize a TRS to invest in non-real estate related assets, which can greatly expand a REIT's investment opportunities. In some cases, REITs can utilize a TRS structure to compete with more traditional private equity firms to purchase an entire enterprise. For example, rather than purchasing only the real estate from an operating business, in some circumstances it may be possible for a REIT to purchase the entire enterprise by isolating the ownership of the operations and non-real estate in a TRS. All real estate assets would be owned by the REIT and leased to the TRS. This type of transaction would need to be carefully structured to ensure compliance with all REIT requirements (including the asset test which requires that the value of all of the REIT's TRSs to be below 20% of the REITs assets).

Qualified REIT Subsidiaries (QRSs)

A QRS is corporation that is owned 100% by a REIT and that does not file an election with the IRS to be treated as a TRS. QRSs are consolidated with the REIT for income and asset testing and nearly all other federal tax purposes (one exception being employment taxes). Accordingly, all assets, liabilities, and items of income, deduction, and credit of a QRS are treated for REIT purposes as assets, liabilities, and items of income, deduction, and credit of the REIT. QRSs are disregarded entities for federal income tax purposes, like single member limited liability companies outside the REIT context. While a QRS is consolidated with the REIT for federal tax purposes, it is treated as a separate legal entity for most legal purposes. Thus, a QRS can be used by a REIT to structure its investments or acquisitions. For example, a REIT may acquire a corporation which directly or indirectly owns real estate. By not electing to be a TRS, the corporation would be a QRS and would be consolidated with the REIT for federal tax purposes.

Advantages and Disadvantages of REITs

Advantages for Investors

There are numerous advantages to investing in a REIT. One advantage to owning a REIT is liquidity. Generally, shares in a REIT (especially one that is publicly traded on an exchange) can be easily transferred. In contrast, direct ownership of real estate is not so easily transferred. Thus, by investing in a REIT, an investor is able to gain exposure to real estate while still maintaining some level of liquidity.

REITs can further ensure liquidity for an investor because they are required to distribute 90% of their taxable income annually. So unlike investments in other enterprises which may not distribute profits frequently, an investor in a REIT can expect a constant stream of income.

In addition, owning real estate directly requires much more involvement by the investor than ownership in a REIT. As a landlord, the investor would be required to correspond with the tenant, collect rents, negotiate leases, and participate in other administrative burdens of owning the real estate. Further, as a landlord an investor could be subject to unlimited liability from third parties. In contrast, an investor's liability for investing in a REIT is generally limited to the amount of the investment. Investors also have the advantage of relying on the expertise of management in handling tenants and selecting and managing the properties.

Another advantage to investing in a REIT is diversification. By investing in a REIT, an investor is able to gain exposure to a portfolio of properties rather than only a single property. Even if one or two properties in a REIT's portfolio turn out to be losing propositions, the other properties in the portfolio may be winners.

Disadvantages for Investors

One disadvantage to investing in a REIT is that the investment is limited to purely real estate (for the most part). In contrast, when investing in an operating business, the investment is in the entire enterprise, which may include real estate and operating assets. However, as discussed above, a REIT may gain exposure to some limited non-real estate related assets through the use of TRS.

Another disadvantage of investing in a REIT is that the price of the shares of the REIT can be volatile as comparted to investing directly in real estate. The shares of a publicly traded REIT can change on a daily basis and can be subject to market fluctuations which are not necessarily tied to the underlying REIT's fundamentals and performance. The price of real estate is generally more stable and is not subject to daily fluctuation based on factors unrelated to its value.

Further, because of the amount and complexity of tax rules affecting REITs, it can sometimes be difficult to understand whether a REIT is complying with all requirements. REITs must spend extensive time and resources complying with these rules and structuring their investments accordingly.

Advantages for Tenants

From a tenant's perspective, REITs can be a creative way to raise capital for a growing business. Rather than obtaining a conventional mortgage loan secured by the business owner's real estate, a business owner can sell their real estate to a REIT and lease it back pursuant to a long-term absolute net lease (typically 10 to 20 years). Because the lease is typically an absolute net lease (see below discussion in Lease Considerations, the tenant remains in possession and control of the day-to-day aspects of the property. Accordingly, the tenant is able to monetize the value of its real estate, obtain funds for working capital, and still maintain possession and control over the property.

Sale-leaseback transactions like the one described in the preceding paragraph have other advantages for tenants as well. For example, conventional banks typically only lend an amount equal to 75% or 80% of the value of the real estate. By selling the property to a REIT, a business owner can extract 100% of the value of the real estate. In addition, mortgage loan rates can rarely be locked in for periods over five or ten years. By utilizing a sale-leaseback transaction, a tenant can lock in its real estate costs for 15 to 20 years. Even though most leases have escalators that increase the rent annually, that cost can at least be budgeted (allowing a tenant to avoid the uncertainty of interest rate fluctuations that can affect conventional loan financing). Business owners may find that using REITs can be a creative way to grow their business or extract some value from their business while still maintaining the necessary level of control.

Another advantage of using REITs as a source of capital is that it can provide flexibility to meet the tax and accounting needs of the tenant. For example, the lease between the REIT and the tenant can be structured as an "operating lease" or a "capital lease" (also called a "financing lease") for tax and accounting purposes. Depending on the tenant's requirements and tax situation, the tenant may elect to structure the lease as either an operating lease or a capital lease (or some combination of both through more than one lease).

Operating leases are treated like a traditional lease in which the property is considered owned by the lessor. Thus, the tenant is generally able to treat the payment of rent as a business expense which can be deducted on its tax return. Further, unlike a loan in which the asset (the real estate) and the corresponding liability (the loan) are reported on the tenant's balance sheet, an operating lease is not reported on the tenant's balance sheet, which can be advantageous to some tenants for financial reporting purposes.

On the other hand, a capital lease is treated as if the tenant is the owner of the property for tax and accounting purposes. This type of accounting and tax treatment typically mirrors the treatment of loan financing (with the tenant recognizing depreciation and interest expenses). Unlike an operating lease, the tenant is required to recognize the present value of the lease payments as a liability on its balance sheet.

Notably, the accounting standards for recognizing operating and capital leases changed on January 1, 2019, with the adoption of ASC 842 which made it harder for tenants to obtain operating lease treatment. This new accounting standard requires leases that were previously classified as operating leases to be reported on the tenant's balance sheet. Accordingly, tenants will need to understand their specific goals as well as the tax and accounting landscape when structuring a lease with a REIT.

Disadvantages for Tenants

One disadvantage for tenants is that negotiating a lease with a REIT can be difficult because the REIT must ensure that all REIT requirements are met. See Lease Considerations below for a discussion involving negotiating a lease with a REIT.

Another drawback that applies to a sale-leaseback transaction with a REIT is that, at the end of the term of the lease, the tenant will no longer have possession and control over the property. At that time, the tenant will need to either negotiate a new lease, repurchase the property for fair market value, or move to a new location. Accordingly, the tenant may want to include a purchase option or right of first refusal regarding a sale of the property.

In addition, by selling the tenant's property to a REIT, the tenant misses out on the appreciation in value of the property. If the tenant obtains conventional financing with a mortgage on the property, the tenant gets the benefit of any appreciation in value in the real estate.

Also, while there are many tax benefits to a sale-leaseback transaction, if the tenant has a low basis in the property, selling to a REIT could trigger a large gain for tax purposes.

Finally, while tenants typically maintain day-to-day control, a REIT will necessarily have some level of control as owner of the property. For example, large capital expenditures and actions which materially affect the property will likely require the REIT's approval. Giving up these types of rights may not be palatable to all business owners.

For information on sale-leaseback transactions, see Sale-Leaseback Transactions and Accounting and Tax Treatment of Sale-Leaseback Transactions.

Joint Ventures with REITs

Developers and sponsors may find that partnering with a REIT can be an effective method to accomplish their real estate goals. REITs can provide an alternative source of capital when a sponsor or developer is unable to obtain financing from a traditional bank. Further, REITs and their management teams typically have a wealth of experience and information in the real estate sector that can be beneficial to sponsor or developer.

Sponsors and developers seeking investment from a REIT must generally understand the REIT requirements discussed in this practice note. If the joint venture is structured as a partnership, the flow through nature of a partnership requires a REIT to account for its proportionate share of the assets and income of the partnership when calculating its income and asset tests. Accordingly, a REIT will require significant restrictions on the joint venture's assets and activities if structured as a partnership. Even if the joint venture is a corporation, care must be taken to ensure that the REIT does not violate any of the asset tests, including the 10/10/5 assets test (relating to ownership of securities) or the requirement that the value of a TRS be less than 20% of the value of the REITs assets.

Another situation in which REITs may enter into a joint venture is when a REIT is divesting of its interest in a portion of its portfolio. For example, a REIT that is too heavily concentrated in one tenant may desire to diversify by selling a portion of its portfolio to a third party, which could be another REIT. This is typically done through an equity transaction in which the outside investor purchases all of the equity ownership in the entity or entities that own the property.

Conversely, a REIT may choose to acquire its real estate through a joint venture arrangement with a proven partner in a specific sector or geographic area. This may be advantageous for a REIT that is entering a new market because it allows the REIT to gain experience and access to the market through the joint venture relationship.

For additional information and sample provisions to be included in a joint venture agreement, see Real Estate Joint Venture Resource Kit (90/10 Real Estate Joint Venture) and REIT Protection Clauses (Joint Ventures).

Lease Considerations

A typical lease with a REIT can vary widely depending on the type of REIT and the industry. However, regardless of the type of REIT or industry, a REIT must ensure that the lease meets all REIT requirements. For example, because the assets and income tests require the REITs activities to be real estate related, the rent generally cannot be based on the cash flow or net profits of the tenant's enterprise. Further, REITs are passive landowners and providing services that are not usually or customarily rendered in connection with real estate can cause problems for a REIT. These restrictions can be problems for some tenants. Regardless of the tenant's concerns, the lease must be carefully structured to ensure compliance with all REIT rules.

Specific provisions in a REIT's lease can differ widely from other commercial real estate leases. For example, the REIT may require that the lease be a true absolute net lease. This goes beyond simply requiring the tenant to be responsible for taxes, insurance, repairs, and maintenance. In an absolute net lease, the tenant is responsible for all costs and risks of owning and operating the property. For example, the REIT landlord will likely require broad indemnity for any activities on the property (environmental or otherwise), whether they occur before, during, or after the lease commences. The REIT may also require the tenant to be responsible for all costs of any kind which may arise in administering the lease.

Another example of an absolute net lease concept is typically found in the casualty and condemnation provisions of the lease. A REIT landlord may require that in a casualty or condemnation event, the tenant must either (1) restore the impacted property, or (2) buy the impacted property. In contrast, a commercial lease that is not absolute net may permit a tenant to terminate the lease (or partially terminate the lease with respect to the impacted property) upon a casualty or condemnation event. However, an absolute net lease shifts the risk of the casualty condemnation to the tenant rather than landlord.

REITs may also utilize a master lease structure if the REIT is leasing multiple properties to a tenant. In this scenario, the REIT would enter into one master lease agreement which governs all properties. One reason for this structure is that if the tenant files for bankruptcy, the tenant is unable to cherry-pick the leased properties from the portfolio. In a bankruptcy, the tenant has the right to assume or reject the lease. If a master lease structure is properly entered into, the tenant would be required to either reject or assume the whole master lease. Thus, the tenant is prevented from picking and choosing which properties to assume or reject.

Finally, a lease with a REIT, particularly an institutional REIT, may resemble a transaction with bank in many respects. REITs may require various credit enhancements such as a letter of credit, guaranty, security agreement, environmental indemnification, and assignment of sublease rents. REITs may also require the tenant to maintain certain financial ratios (similar to a loan agreement) and deliver certain financial information on a monthly or quarterly basis. A REIT may also require the tenant to be a single purpose entity. Further, in some cases, REITs may purchase a small equity interest in the tenant for the sole purpose of providing the REIT a veto right in the event of a bankruptcy. Typically, all agreements are cross-defaulted and cross-collateralized. Accordingly, with respect to a tenant who leases multiple properties from the REIT, a default relating to one property will cause a default at all properties.

For leasing resources, see Office Leasing Resource Kit and Retail Leasing Resource Kit.

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Mr. Gordon's practice includes representing publicly traded companies and closely-held businesses in connection with a wide variety of corporate and real estate matters.

He frequently represents REITs and real estate developers with sale/leaseback transactions, joint ventures, real estate developments and other complex transactions that often range from $10 million to in excess of $1 billion.

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