REIT Issues for Retail Leasing Professionals

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When a shopping center or other mixed-use development that contains retail is owned by a real estate investment trust (REIT), special care must be taken in negotiating tenant leases that are REIT-compliant. These REIT rules can be frustratingly at odds with common commercial practice at times, but with proper planning and structuring, REIT landlords and their retail tenants can often agree to terms that are both REIT-compliant and commercial.

Income considerations

REITs, like partnerships or LLCs, generally avoid income tax liability at the entity level. Unlike partnerships or LLCs, however, a REIT must meet certain tests to maintain its tax-favored status. In the retail leasing context, the compliance focus is on whether a REIT landlord could have "disqualified" rent under the lease. Such disqualified rent would prevent the REIT from meeting its income test requirements. Although there are many reasons that rent could be non-qualifying for a REIT, most issues in the marketplace today have to do with tenant services or percentage rent formulas with unusual terms. Under the special tax rules for REITs, impermissible tenant services can transform otherwise good REIT rental income into non-qualifying income, with extremely serious consequences for the REIT's tax-favored status.

"Good" rents

"Good" rents include: (1) amounts paid for use or occupancy of real property, (2) charges for services customarily furnished in connection with the rent of real property and (3) rent attributable to personal property leased in connection with a lease of real property, provided that the rent attributable to the personal property does not exceed certain limits. A service is customary if, in the geographic market in which the property is located, tenants in a similar class of building are customarily provided with the same service. Many everyday payments that flow from the tenant to the landlord are considered rent under these rules, even when such payments are not strictly for the use of space. For example, reimbursements for real property taxes and common area maintenance, interest on unpaid rent, and additional amounts received by a landlord from a tenant in the event of

a sublease or assignment may all generally be treated as qualifying rent for REIT purposes. In addition, items that the IRS has ruled are customary services for retail tenants include the provision of electricity, elevator services and trash removal; property security; administrative support for merchants' associations; and common area repair and maintenance. Finally, for rent to be qualifying income for the REIT, it cannot be contingent upon income or profits of any person (including subtenants) from the property.

Percentage rents

Although rent contingent on profits is not qualifying, rents based on a percentage of the tenant's gross sales are permitted from a REIT perspective. The interaction of these two rules can sometimes generate confusion based upon how "gross sales" are defined in the lease. In some cases, unusual or excessive exclusions from the "gross sales" definition in the lease could make it unclear whether the percentage rent under the lease is more properly characterized as rent based upon profits, not gross sales, of the tenant.

Typical exclusions from the definition of gross sales do not generally pose any REIT concerns. Thus, when gross sales excludes, for example, adjustments for returned or exchanged merchandise, internet or catalog sales, or payments to credit card processors, there is no reason for concern that the rent under the lease is based on net profits. On the other hand, exclusions related to payments to third-party vendors, or that offset labor costs, should give REIT advisors pause. For example, what if a restaurant tenant wanted to exclude electronic booking fees from websites such as Open Table from gross sales? Or what if an apparel company wanted to exclude sales made at a reduced price to its social media brand ambassadors? In such cases, it becomes harder to differentiate between gross sales and net profits. Therefore, REIT landlords will typically resist such exclusions in lease negotiations. Further, as retailers themselves begin to offer more services along with their consumer products offerings (e.g., technology training at a consumer electronics store; yoga classes at an athleisure store, etc.), REIT landlords will have to grapple with whether such offerings are truly loss leaders for the retailers or whether they are a new source of revenues from the leased premises.

"Impermissible tenant service income"(ITSI)

Although today friction between tenants and REIT landlords from unusual exclusions from gross sales may occasionally arise, the real issues in most retail leases involving REITs have to do with "impermissible tenant services income" or ITSI. Under the rules for good rents described above, a REIT cannot furnish non-customary services in excess of a de minimis threshold of 1 percent of all amounts received from the premises. ITSI can pose unique problems for REIT compliance for two reasons: (1) non-customary tenant services do not have to be separately charged for (i.e., they can

just be included in the rent) and therefore can be difficult for compliance professionals to identify and (2) income from such services can taint otherwise "good" rental income, jeopardizing the REIT's tax-favored status.

Some examples of services that may give rise to ITSI if furnished directly by a REIT include repair or maintenance of the leased premises beyond the landlord's general maintenance obligations; construction of improvements the tenant is otherwise obligated to construct; additional security beyond the general security of the property as a whole; concierge services; and valet parking. On the other hand, customary tenant services typically include those services that are provided in connection with the rental of space for occupancy only and not primarily for the tenant's convenience. Examples include basic services like trash removal, utilities, common area cleaning, common area janitorial services and supervising construction of improvements made by a tenant.

In today's challenging retail environment, both landlords and tenants are constantly looking for new ways to drive traffic to stores and shopping centers. Often this involves pushing the boundaries on tenant services to entice shoppers and increase foot traffic. For example, one landlord acceded to a tenant request to operate a shuttle for the tenant's customers to and from a nearby hotel. Another landlord agreed to run social media promotions for a tenant. Yet another tenant persuaded a landlord to provide snow removal services at the tenant's parking lot. The negotiation of parking arrangements at urban centers can be particularly involved. Aside from valet parking, urban centers often provide for discounted or "validated" parking for customers who can show a receipt from a tenant's store or other parking discounts and promotions. Depending on how the parking lot is owned and operated, such discounts may run afoul of the REIT rules. All of these examples would typically be characterized as non-customary services that could taint the rents for the REIT landlord. As traditional retail shrinks and shopping centers reorient themselves around service-oriented tenants (e.g., medical and fitness) and entertainment (movies, restaurants and other entertainment such as video arcades, games, trampoline parks, etc.), novel questions about tenant services will continue to arise. This is especially true because the test for what is "customary" necessarily implies that landlords who wish to be market leaders will constantly be pushing the envelope, not merely providing their tenants with what is customary in the marketplace.

Taxable REIT subsidiary (TRS)

Because ITSI can be difficult to catch in the context of a retail lease, most REIT landlords will include a "savings" provision in a retail lease. Such a provision will typically provide the REIT with the ability to adjust any rents under the lease to bring these payments into compliance with the various rules described in this article. In addition, REIT landlords will want the right to review any sublease and assignment to ensure that it is not based on profits of the subtenant or assignee.

While the first challenge for the REIT landlord is identifying the tenant service and determining whether it is customary, the second challenge is finding a structure to accommodate any non-customary services the REIT landlord is willing to provide. Fortunately, such non-customary services may be provided to tenants through a special subsidiary of the REIT landlord known as a "taxable REIT subsidiary" (TRS). A TRS, unlike a REIT, does pay tax at the entity level, and is therefore not subject to the same restrictions on income from tenant services as the REIT landlord. However, while the TRS solution is helpful from a compliance standpoint, it can be economically costly. When the REIT provides a service through a TRS, it must pay the TRS to furnish the service, and the payment to the TRS must have a markup over the cost to the TRS of actually providing the service. For example, if the REIT wished to provide the non-customary shuttle service described above through a TRS and the cost of the service was $80 per day, the REIT would have to pay the TRS $100 per day to provide the service. This would leave the TRS with a 20 percent profit margin, on which it would be subject to tax. As this example shows, providing non-customary services through a TRS can often create a drag on the REIT landlord's economics. Although beyond the scope of this article, certain tenant services (especially parking) may be furnished by an independent contractor engaged by the REIT, avoiding the need for a markup and leaving the REIT with less economic cost and more economic profit relating to the tenant service.

Conclusion

As retail leasing continues to evolve, REIT landlords, their retail tenants and the business and advisory teams on both sides of a retail lease will want to ensure that REIT issues are discovered and negotiated before the lease is signed. This will avert any unpleasant surprises and the need for renegotiation down the road. With proper planning, the vast majority of REIT issues arising in retail leases can be effectively managed.

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