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A Primer on Using Private Domestically Controlled REITs for International Investors in U.S. Real Estate

By John Grumbacher, Robert Towsner, Steven Schneider, and Elizabeth Norman*

International investors are increasingly important players in U.S. financial markets, including U.S. real estate.¹ International investors from a treaty country generally pay no U.S. tax on the capital gains from dispositions of U.S. corporate stock. When such investors consider investments in U.S. real estate, they look to replicate this no-tax result.

In the U.S., one investment vehicle that achieves this objective for real estate investments is a domestically controlled private real estate investment trust (a “Private DC REIT”). The benefits of this structure are predicated on (1) the Private DC REIT not selling its real estate while the international investor is a shareholder, and (2) the international investor ultimately exiting its investment by selling its Private DC REIT shares. Despite these limitations, the Private DC REIT remains an excellent option for international investors looking to invest in U.S. real estate without paying tax on capital gains. This three-part article pro-

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¹ This article uses the term “international investors” to describe non-U.S. investors. According to the U.S. Department of Commerce, in 2011 international investors invested approximately \$234 billion in U.S. businesses, including approximately \$48.4 billion in U.S. real estate. U.S. Congressional Research Service, *Foreign Direct Investment in the United States: An Economic Analysis*, James K. Jackson (10/26/12).

vides a primer on how to structure Private DC REITs, handle costs imposed on U.S. shareholders, and negotiate the joint venture agreement.

STRUCTURING THE REIT

The first part of this article focuses on how the rules applicable to REITs affect the structuring and business challenges of co-investment with an international investor through a Private DC REIT.² Part I will also summarize general tax issues confronting international investors in U.S. real estate, and will address how these issues can be mitigated through the use of a Private DC REIT.

Top 5 Business Aspects of a Domestically Controlled Private REIT

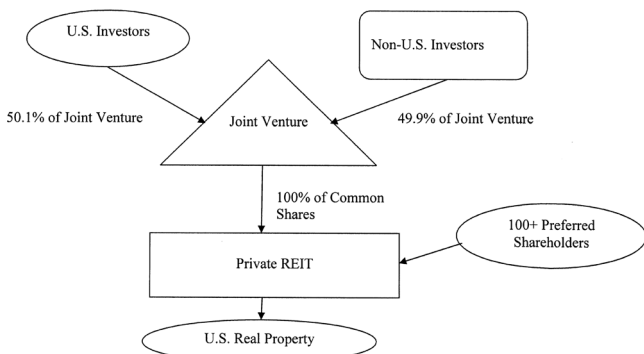
1. U.S. investors must own, directly or indirectly, more than 50% of the value of all of the REIT’s shares.
2. The international investor must exit the investment by selling REIT stock (although the buyer likely will require all investors to sell their REIT shares in order to achieve a step-up in basis for the property and reduce future U.S. taxes). As the buyer of a pre-existing entity’s stock, the buyer will require various representations and a deep-pocket indemnity relating to past REIT qualification, as well as other entity-related matters that typically are not issues that arise with a direct transfer of real estate. These complications may also cause the buyer to offer a lower price as compared to an asset purchase.

² This article addresses only the tax treatment of so-called “equity” REITs that invest directly or indirectly in U.S. real property rather than in debt instruments secured by real property. It does not attempt to describe the tax treatment of REITs investing in secured debt instruments. In addition, REITs are subject to a number of restrictions on their ownership and operation of real estate. These restrictions relate to such matters as contingent rents based on net income, the provision of noncustomary services to tenants, and limitations on the operation of hotels and health clubs. Because these restrictions are well-known in the industry, are the subject of myriad, easily accessible articles, and generally do not have a material effect on the economics of the REIT, they will not be addressed in this article.

3. Investments must meet REIT income and asset requirements, requiring annual testing of income and quarterly testing of assets, as well as review of leases and services to maintain REIT qualification.
4. More than 50% of the REIT's shares, by value, cannot be held by five or fewer individuals, generally restricting each direct and indirect individual owner to less than 10% ownership.³
5. A REIT must have over 100 direct shareholders, which is generally satisfied for private REITs by specialty companies providing approximately 115–125 accredited investors for \$1,000 of preferred stock each.

Typical Structure of a Domestically Controlled Private REIT

Subject to closely held and domestically controlled transfer restrictions



International Investors in U.S. Real Estate, Generally

The two key issues that affect the manner in which international investors invest in U.S. real estate are tax return filing obligations and income taxes.

U.S. Tax Return Filings

An international investor who owns U.S. real estate (directly or through a flow-through or “fiscally transparent” entity for U.S. tax purposes) generally is required to file state income tax returns in each state in which the U.S. real estate is located, in addition to a federal income tax return. To avoid these U.S. tax filing obligations, international investors often make their investment in U.S. real estate through a U.S. corporation, typically referred to as a “blocker,” because it blocks these filing obligations and imposes them on the U.S. corporation instead. A REIT is a corporation for this purpose and as such generally serves to minimize U.S. tax filing obligations.

³ Certain entities are treated as “individuals” for this purpose, but they are not usually involved in this type of real estate investment.

U.S. Income Taxes — Corporate Tax and FIRPTA Tax

As a practical matter, REITs generally distribute all of their taxable earnings to avoid corporate-level income taxes on any undistributed taxable earnings.⁴ Generally, a U.S. corporation that is not a REIT is taxable on all of its income, whether from operations or capital transactions, with a top federal rate of 35% plus state and local taxes that vary significantly, depending on the state (and sometimes the city) where the corporation’s property is located.⁵

REITs, however, are subject to a special tax regime under which distributions to shareholders are deductible in computing taxable income, effectively eliminating corporate taxes at the REIT level. To qualify as a REIT, the REIT must distribute at least 90% of its taxable non-capital gain income⁶ to its shareholders each year and, further, any undistributed earnings, whether ordinary or capital, are subject to corporate tax.⁷ The net result is that REITs distribute all or nearly all of their operating income and gains each year to their shareholders.

Distributions by REITs to their shareholders are characterized as dividends under U.S. law and most treaties. Most dividends paid to international shareholders are subject to U.S. tax at a flat 30% rate. Although that rate may be (and often is) reduced by treaty, REIT dividends may be subject to a less favorable withholding rate than regular dividends.⁸

Special rules generally subject both capital gain dividends⁹ and gains from the sale of non-domestically controlled REIT stock to U.S. income

⁴ A “consent dividend” provides an opportunity for the REIT to be treated as making a dividend for tax purposes without the need to actually distribute cash. See generally §§561(a) and 565. Unless otherwise stated, references to “§” or “Section” are to sections of the Internal Revenue Code (26 USC).

⁵ For a chart of state income tax rates, see http://www.taxadmin.org/fta/rate/corp_inc.pdf. Top rates for some of the most common state jurisdictions for international investors are: Washington, DC (9.975%); California State (8.84%); Massachusetts (8.0%); and New York State (7.1%).

⁶ Capital gains and certain other types of income are subject to special treatment and are not included for the purpose of applying the 90% test. Capital gains are not required to be distributed, but any undistributed capital gains are subject to taxation at applicable corporate rates. As a result, it is very rare for any public and private REITs not to distribute all capital gains.

⁷ §857(a).

⁸ The rationale for this distinction is that a REIT, unlike a regular corporation, normally does not pay tax at the entity level and thus does not need a lower withholding tax rate on its dividends to mitigate double taxation.

⁹ Although most REIT dividends will be taxed at a flat 30% or lower treaty rate (if applicable), to the extent that the source of the dividend is gain from the sale of U.S. real estate, the dividend is subject to tax under FIRPTA. The amount subject to FIRPTA tax is the amount designated by the REIT as a capital gain dividend. International investors receiving designated capital gain dividends are taxable on those dividends in the U.S. at graduated federal income tax rates. If the international investor is a corporation, the corporate rates apply (which is generally 35% and does

tax. Specifically, the Foreign Investment in Real Property Tax Act (“FIRPTA”) generally provides that income and gain from the disposition of U.S. real estate must be subjected to U.S. tax.¹⁰ FIRPTA treats capital gain dividends from REITs that are *not* domestically controlled as “effectively connected income,” which is subject to tax at normal graduated U.S. rates.¹¹ If the real estate is held by a corporation (such as a REIT), these rules also taint the sale of the corporate stock if the corporation is a United States Real Property Holding Corporation (“USRPHC”). In general, a corporation is considered a USRPHC if 50% or more of the gross value of a corporation’s assets in the year of sale or in any of the previous five years is attributable to U.S. real estate.

Equity REITs are, by definition, USRPHCs, because investments in U.S. real estate represent far more than 50% of the gross value of their assets.¹² As a result, the sale of the stock of a REIT by an international shareholder is subject to U.S. tax unless the REIT is exempt from USRPHC status. FIRPTA grants this exemption to domestically controlled REITs.¹³ Where this exemption applies, an international shareholder is not taxed on the sale of its REIT stock.¹⁴ It is for this reason that international investors prefer to invest through Private DC REITs.¹⁵

A Typical International Investor Structure for Investment in a Private DC REIT

To avoid U.S. tax liability, an international investor in a Private DC REIT must ensure that the REIT does not sell its real property while the international investor is a shareholder and that the international investor can dispose of its REIT shares to achieve liquidity and realize on its investment. The REIT must maintain its REIT qualification throughout the international investor’s investment and must also qualify as a domestically controlled REIT. This requires the REIT to meet the following stock ownership tests, some of which are applied only to direct investors in the REIT, while

not have a capital gains tax rate preference). If the international investor is an individual, the capital gains tax rate preference applies (generally 20%). International investors who do not have state nexus will not be subject to state tax on dividends received by the REIT. Hellerstein & Hellerstein, *State Taxation* 9.10 (Reuters/Tax & Accounting, 3rd ed. 2001, with updates through July 2013) (online version accessed on Checkpoint (www.checkpoint.riag.com) (9/9/13)).

¹⁰ §897.

¹¹ §897(a)(1).

¹² See §897(c)(2).

¹³ There is also exception for stock of a corporation that is regularly traded on an established securities market if the investor has not owned more than 5% of the stock during the applicable testing period. §897(c)(3).

¹⁴ §897(h)(1).

¹⁵ To some extent, the advantages of this structure to international investors may depend on the level of taxation in the international investor’s home country.

others are applied on a look-through basis¹⁶ to some or all ultimate investors.

100 Shareholder Requirement

The 100 direct shareholder test¹⁷ is the easiest to satisfy. This is typically done by issuing non-voting preferred shares to between 115 and 125 investors. Shares are typically priced at U.S. \$1,000, are subject to redemption at par plus accrued but unpaid dividends, and pay a fixed dividend. A limited number of these preferred shares are sold, and often no more than \$125,000 is invested in these shares in the aggregate. Dividend rates in the 12–15% rate range are common.

An industry has emerged to facilitate the investment by preferred holders and manage investor relations. For example, a firm may charge approximately \$17,000 in up-front fees and expenses for each REIT, together with approximately \$9,000 in additional annual charges for the administration of each REIT.¹⁸ The convenience of a specialized company can be helpful because it has the procedures in place to track the investors as they change over time, something that is often lacking for an offering of preferred shares to friends and family (another option for meeting the 100 direct shareholder test).

Cannot Be “Closely Held” — The 5 and 50% Test

A REIT will lose its favorable U.S. tax classification if 5 or fewer individuals collectively own more than 50%, by value, of the REIT’s shares.¹⁹ Ownership is tested by looking up through the chain of direct and indirect ownership, with shares owned by entities generally treated as if owned proportionately by their equity holders. As a result of these look-through rules, it is necessary to restrict transfers of both directly and indirectly held REIT shares. Because the consequences of loss of REIT status are so dire — the corporation becomes fully taxable on its income and sales of its shares are fully taxable to international shareholders — these restrictions are generally enforced by draconian measures.

Thus, it is common for REIT organizational documents to limit the ownership of any one shareholder

¹⁶ For example, most private pension plans are treated as owned by their beneficiaries based on their actuarial interests, while REIT shares held through partnerships or corporations are generally treated as held proportionately by the partners or shareholders.

¹⁷ §856(a)(5).

¹⁸ A Private DC REIT will generate additional incremental costs as compared to an investment in real property. These costs would include the legal and accounting costs to form and monitor the compliance of the REIT and the cost of obtaining and maintaining the preferred shareholders. These incremental expenses tend to range between \$75,000 and \$300,000 or more. The middle of this range is likely to apply in most cases, although legal costs can be significantly higher where the properties involved are hotels or health care facilities because of the special rules and structuring that must be done if these types of assets are held through a REIT.

¹⁹ See §§856(a)(6) and (h), 542(a)(2).

to not more than 9.9% of the REIT's shares so that any five shareholders cannot own more than 49.5% of the REIT's shares. Similar restrictions are also imposed on all higher tier entities in the chain of ownership. Shares that violate these limits are typically called "excess shares." A REIT's organizational documents often require that the beneficial owner of excess shares automatically loses any economic return on those shares. This is accomplished by having the excess shares transferred to a separate trust that can only benefit one or more U.S. charities. When it is known at the outset that any individual investor will exceed the 9.9% threshold, the maximum share ownership percentage is adjusted downward to ensure that the 5 and 50% test will always be met. Thus, if two investors collectively own 30% of the shares of a REIT at the outset, no other investor would be permitted to own more than 6.5% of the REIT's shares so that the top five holders could not own more than 49.5% of the REIT. In this situation, the initial two investors would be subject to the "excess share" provisions if they acquired, directly or indirectly, any additional shares.

Domestically Controlled Requirement

A REIT is domestically controlled only if international investors own, directly or indirectly, less than 50%, by value, of the REIT's shares.²⁰ Assuming that the international investor wants to maximize its holdings in U.S. real estate without losing the benefit of domestically controlled status, the international investors could acquire just under 50% of the REIT's shares, by value, with the remainder held by one or more U.S. investors, often through a U.S. fund. In that case, ownership of the U.S. fund would need to be reviewed and monitored to ensure that any direct or indirect international investor in the fund does not cause the REIT to violate this important limitation.

DEALING WITH COSTS IMPOSED ON U.S. INVESTORS

The first part of this article focused primarily on the advantages to an international investor of investing through a Private DC REIT. This second part addresses how the structure of the Private DC REIT affects the U.S. co-investors and what can be done to minimize any adverse impact of the structure.

Effects on U.S. Co-Investors

U.S. investors considering joint investments in U.S. real estate with an international investor will need to work within the limitations imposed by the Private DC REIT structure and will face issues not present in

direct or flow-through investments in U.S. real estate, principally (but not exclusively) related to the international investor's ultimate exit from its investment.

Transferring Appreciated Property to the REIT

If the real property that will be held by the REIT is already held by the U.S. investor and has appreciated in value in that investor's hands, it is critical that the U.S. investor first sell a 49.9% interest in the real estate to the international investor and that the international investor and U.S. investor then contribute their respective shares of the real estate to the Private DC REIT.

The failure to use this form will either deprive the REIT of any step-up in basis for the appreciation in the property or will require the U.S. investors to recognize 100% of the appreciation in the real estate as taxable gain, depending on whether the international investor has a binding commitment to purchase the REIT shares when the property is transferred to the REIT. Where 49.9% of the property is first sold to the Private DC REIT, the REIT obtains a step-up in basis on this 49.9% interest and the remaining 50.1% of the real estate is transferred to the REIT in a tax-free transaction.

Effect of Step-Up in Basis on Sale Economics

As noted above, the international investor will insist that the Private REIT be domestically controlled so that the international investor can sell its REIT shares and avoid taxation of its gain under FIRPTA. The buyer of the REIT shares will simply step into the international investor's shoes as the owner of corporate shares. The REIT's tax basis in its real estate will not be affected by the sale, so that the amount of tax depreciation available to the buyer will not change to take into account the appreciation in the REIT's assets while the international investor held its shares. If the REIT sold its real estate directly to the buyer, the buyer would obtain a new tax basis in the real estate equal to the amount it pays to the REIT (including assumed/subject to debt), commonly called a "step-up in basis." Effectively, when the real estate (rather than the REIT's shares) is sold, the appreciation while the seller held the property is converted into future tax deferral for the buyer.

This step-up in basis cannot be obtained where the international investor sells its shares unless the U.S. owners sell their shares to the buyer as well. If both the U.S. and international investors sell their shares, the buyer will typically liquidate the REIT and take advantage of the REIT's ability to deduct distributions paid to its shareholders so that no tax is imposed at the REIT level. The buyer will have gain on the liquidation to the extent that the value of the distributed real estate and other assets (net of liabilities) exceeds what the buyer just paid for the REIT's shares.

This places a premium on liquidating soon after the buyer acquires the shares and avoiding creating any evidence that the IRS could use to show that the net value of the real estate exceeds what the buyer paid for the REIT shares. However, the buyer should not be under any obligation to liquidate the REIT to mini-

²⁰ §897(h)(4)(B). Some have considered having some of the international investor's shares held through a U.S. corporation in an attempt to reduce the amount of foreign ownership arising from the international investor. Although there is support based on PLR 200923001, we understand that government representatives have cautioned against using this structure.

mize the risk that the transaction could be recharacterized as, in substance, a sale of the underlying asset and not of the REIT stock.

For example, if the REIT shares are sold through an auction, it will be better for the winning bidder if separate bids are not obtained for the underlying real estate. Any bid for a direct purchase of the real estate will likely be higher than the price for the REIT shares, for the reasons previously stated. But this could mean that when the buyer liquidates the REIT the net value of the real estate it receives in liquidation will exceed what the buyer just paid for the REIT stock, which would result in taxable gain to the buyer.

It is important to note that — for various technical reasons — this method of achieving a step-up in basis by having the Private DC REIT liquidate after its shares have been acquired by the buyer is not available if the buyer is, itself, a REIT. This result is because the liquidation would be tax-free under §332, and the lower “inside basis” in the underlying real estate would pass to the acquiring REIT on liquidation. This fact reduces the population of buyers when the investors decide to exit their investment.²¹

U.S. investors in Private DC REITs should expect incremental legal and accounting costs on exit of around \$50,000, while a buyer’s incremental legal and accounting costs are likely to run between \$50,000 and \$150,000.²²

Impact of REIT Restrictions on Economic Return

The tax rules restrict REITs to primarily passive real estate investments, which creates compliance costs and prevents the REIT from earning certain types of income. For example, a REIT is subject to a 100% income tax on so-called “dealer income,” and to avoid this draconian tax a REIT will not engage in certain business models, such as developing condominiums, and will generally hold properties for a minimum of two years. Although a REIT is allowed to indirectly earn some dealer income through a Taxable REIT Subsidiary (“TRS”), this comes at the price of corporate tax at the TRS level. REITs are also generally prohibited from engaging in certain “non-customary” services and are typically not allowed to provide subsidized cafeterias, shuttle services, fitness rooms, concierge services, and valet parking. In addition, rental income received by the REIT cannot be based on the net income of the tenant (but because rent can be based on a tenant’s gross income, this income limitation is typically not a material limitation).

Collateral Effects on the Sale Transaction

From the buyer’s perspective, purchasing REIT shares is different than purchasing a direct interest in the REIT’s real estate. When it acquires REIT shares,

²¹ This effective disqualification of REITs as buyers of Private DC REIT shares is not present where the REIT is a publicly traded UPREIT if the purchase is done by the operating partnership and not the REIT.

²² These amounts are in addition to the up-front and annual costs described in the first part of this article.

the buyer is acquiring an interest in an entity with a history and thus potential, disclosed and undisclosed liabilities. As a result, the documentation for a sale of REIT shares will differ materially from the documentation for the sale of a parcel of real estate.

In the authors’ experience, when compared to the acquisition of real estate directly, the following are areas of focus by the purchaser of REIT shares:

- *Representation and Warranties — Scope.* The buyer will usually require that representations and warranties related to the historic activities of the REIT extend for three years or more and that tax-related representations and warranties extend until the expiration of the statute of limitations for assessment of tax against the REIT.²³ In the case of a purchase and sale of direct interests in real estate it is more typical for real estate-related representations and warranties to expire between 6 and 18 months after closing.
- *Representation and Warranties — Guarantor.* The buyer will usually require a credit-worthy seller or affiliate to stand behind any representations and warranties, particularly with respect to liabilities arising out of the REIT’s status as a separate entity with special tax status.
- *Purchase Price and Basis Step-Up.* Unless the U.S. investor is willing to give the international investor a drag-along right so that all parties are exiting simultaneously, the buyer on exit will not qualify for a step-up in basis. This will make an investment in this real estate less attractive to future buyers unless the U.S. investors sell at the same time. If they are unwilling to do this, the buyer most likely will decrease the price it is willing to offer.
- *Buy-Sell Arrangements.* The negotiation and drafting of buy-sell arrangements are significantly complicated by the need to take into account whether or not the buyer will obtain additional tax deferral from increased tax depreciation on the property and how any diminution in the value of that interest arising from the absence of a step-up in basis should be shared among the parties.

NEGOTIATING THE JOINT VENTURE AGREEMENT

The third part of this article discusses how to structure and negotiate the joint venture agreement for the

²³ The statute of limitations for assessment of taxes is generally three years from the date of filing of the relevant tax return, although this may be extended to six years in certain instances. This continuing liability also raises the question of how the long-term contingent liability for a breach of the representations and warranties is recorded for financial accounting purposes.

entity that will own the REIT. What restrictions will the joint venture need to assure domestic control and general REIT compliance for the underlying REIT? What unique considerations exist with an international member of the joint venture? Also, how should the joint venture address cost sharing among the owners as it relates to unique costs incurred by the structure?

Why a Joint Venture?

Typically, a joint venture will be formed to own all of the common shares of the REIT.²⁴ The joint venture can be in the form of a limited partnership or a limited liability company.²⁵ A joint venture entity allows easier navigation amidst various REIT qualification rules and the investors' economic and control objectives. For example:

- **Free Transferability.** The joint venture can limit the transferability of its common shares so that the parties can control who their partners are. REITs cannot achieve this directly, because their shares are required to be freely transferable.
- **Complex Waterfalls, Including Preferred Returns.** While it is true that most waterfalls can be affected through a corporate structure, it is much easier to draft an understandable waterfall using a joint venture. This is particularly the case where priority preferred returns and catch-ups are desired or where there are "clawback" provisions.
- **Preferential Dividends.** REITs are prohibited from paying preferential dividends, which include dividends at different rates on the same class of shares.²⁶ Where the REIT is owned by a joint venture, different dividend rates and fee loads can be accomplished at the joint venture level without risking disqualification of the REIT.
- **Management.** Joint ventures are more flexible and can bind the entity more effectively than similar provisions in a corporate context. REITs require "centralized" management. In the typical joint venture, there is an "operating" partner/manager and a number of "major decisions" that

require the approval of the larger investors. Those investors may insist on the right to force a sale or refinancing and often will also require their consent be obtained for any sale or refinancing proposed by the operator. While these limitations can be accomplished in a centralized management environment, the mechanisms to accomplish this are often cumbersome and formalistic. Addressing the resolution of an impasse and other similar joint venture management issues is also much more difficult in practice, if achievable at all, if the investors invest directly in the REIT rather than through a joint venture.

What Is Unique to This Type of Joint Venture?

Most of the issues unique to the joint venture structure arise out of the difficulty in achieving a step-up in basis in the underlying real property when the U.S. investors or the international investor (but not both) wish to exit. As described in the second part of this article, the international investor will insist that its exit be accomplished through the sale of the REIT's shares (directly or via the sale of interests in the joint venture) rather than by a sale of the underlying real estate. The buyer of those shares can achieve a step-up in basis only if the REIT is liquidated after the sale of its shares. However, a REIT liquidation will accelerate the tax for any U.S. investors who are not sellers and cause a tax to the international investor if it remains in the joint venture.²⁷ This tax would occur at a time when no cash would be available from the investment to defray the tax liability.

The need to sell REIT shares, rather than the underlying real estate, materially changes the issues professional advisors and their clients must consider in drafting the joint venture agreement. For example, the joint venture agreement will need to address:

- **Sharing of Incremental Costs.** A purchase and sale agreement for REIT shares will be a more complicated and closely negotiated document than an agreement for the purchase and sale of real estate. The buyer will insist on being protected from debts and other liabilities of the REIT, known and unknown (other than secured debt), as well as receiving assurance of REIT qualification in pre-sale years. This protection will need to be supplied by a surviving deep pocket. A legal opinion on REIT qualification may also be required.

Outside advisors can be asked to divide the bills for their services between costs

²⁴ This excludes the shares held by preferred shareholders in order to meet the minimum 100 shareholder requirement.

²⁵ The choice of form likely will be driven by whether there are any international investors whose tax treatment in their country of tax residence depends on whether the joint venture will be a pass-through for tax purposes under the laws of their tax residence. Careful attention should be paid to the treatment of hybrid entities under those laws and under any applicable tax treaties, particularly where limited liability companies (LLCs) are to be used, as other countries and treaties may accord LLCs disparate treatment.

²⁶ Some recent private rulings have permitted REIT shares to be issued with different "loads" and sharing of performance-based fees. See PLR 201109003, PLR 201119025.

²⁷ Although the REIT can avoid the entity-level corporate tax through the dividends paid deduction, all of the shareholders will be taxed as if they sold their REIT stock for fair market value.

and expenses that would have been incurred in any real estate transaction and those occasioned primarily because of the involvement of the REIT and the potential absence of a step-up in basis. Given the amount of judgment required to make these allocations, it is often best to agree in advance on a dollar amount that the international investor will be asked to cover to defray the cost of the structure used to minimize its taxes.

In addition, the REIT will incur annual audit and tax return preparation costs, which are significantly higher for REITs than where the property is held directly by a joint venture. These costs can be expected to add \$100,000 to \$150,000 per year in operating costs for the structure. And, of course, there are the additional costs of having the 100+ preferred shareholders required for REIT qualification.²⁸

- *The Exit Sale Process.* The manner in which bids will be sought needs to be thought through at the outset. Bringing real estate to market where the buyer knows it will be required to take over the old REIT can have a chilling effect on the marketing process. As a result, in the initial stages the marketing materials may not even mention the intent to sell REIT shares but require that the buyer start with an offer for the underlying real estate. Although this staged bid process has become more common, it often will result in buyers inexperienced in REIT matters acquiring the REIT's shares. These buyers will need to be tutored by their professional advisors on what is necessary to maintain REIT qualification.
- *Are the Costs Just Too High?* In the authors' experience, these complications and the various (generally fixed) costs of REIT set up, preferred shareholders and annual compliance, together with incremental exit costs and the need to educate less sophisticated co-venturers on REIT restrictions and compliance obligations, make Private DC REITs difficult to use economically unless the real estate is worth more than \$25 to \$50 million at the outset. Advisors should also consider whether the inability

to effect a §1031 like-kind exchange exit is too limiting.²⁹

Providing for Liquidity

Real estate joint ventures typically include provisions providing a mechanism for liquidity when one party wishes to sell and the other does not, generally calculating the amount one partner must pay to buy the other out based on the value of the property and each partner's distribution rights under the waterfall. Where REIT shares must be sold, rather than the underlying real estate, will the selling partner be granted drag-along rights? If so, standard liquidity provisions will work fairly effectively.

Where the partners have different exit horizons or otherwise are unwilling to grant drag-along rights, there can be no assurance that the buyer will be able to force a liquidation of the REIT to achieve a step-up in basis for the real estate.

The following issues will affect the negotiating postures of the partners:

- If the U.S. investor is the buyer, it may need additional time to locate new money that is willing to continue to invest in REIT shares. For example, a tax-exempt investor may be willing to acquire REIT shares because it does not need the tax shelter of a step-up in basis. A new investor that is not tax-exempt will need to take into account the fact that the REIT's taxable income will be higher because of the lack of additional depreciation that would be available if a step-up in basis were achieved. With higher taxable income, the REIT will be forced to make higher distributions to shareholders to maintain its tax qualification and minimize corporate-level taxes. Annual distributions will be higher as will the investor's tax liability, because the REIT will not derive additional depreciation deductions from a step-up in basis.
- If the U.S. investor wishes to sell, the international investor will need sufficient time to find investors to acquire the U.S. investor's shares so that the REIT remains qualified and continues to be domestically controlled. For example, all of the buyers will need to be U.S. persons so that international investors do not own more than 50% of the REIT.
- A buyer may pay materially less to acquire REIT shares than it would be willing to pay to acquire the real property outright. The parties need to negotiate who should bear the reduction in purchase price and how that reduction is to be determined.

²⁸ As indicated in the first part of this article, in the authors' experience, up-front fees of \$17,000 per REIT and annual fees of \$9,000 per REIT are common.

²⁹ Because the international investor will insist on a sale of REIT shares, like kind exchange treatment under §1031 will not be available.

This issue is exacerbated if separate bids for the real estate and the REIT shares are not obtained. It is best for the parties to negotiate these issues at the outset and take them into account in determining the price at which the liquidity will be achieved by either party.

- Where there are multiple investors other than the international investor, the drafting of liquidity provisions can get materially more complicated, depending on the tax posture of the other investors. The liquidity provisions will need to accommodate each of the permutations of continuing partners and will vary depending on whether the international investor is selling and whether the buyer is, itself, an international investor and whether the other investors have any special tax status (e.g., a tax-exempt entity). Here, there is no substitute for the task of considering each of the possible ownership structures after one partner has sold out and reading the draft provisions to ensure that they achieve the desired outcome in each instance.

In some instances, these liquidity issues become too thorny and the parties may resort to imposition of a forced sale mechanism accompanied with a right of first offer. This is, however, a materially different economic relationship in which one partner may be able to force the other to sell when it would not otherwise do so.

State Tax and Consent Dividends

While state income tax matters are generally beyond the scope of this article, there are two particular traps for the unwary that should be taken into account in the business negotiations.

One problem arises, for example, where the REIT has made capital expenditures on its property. If the capital expenditures are not funded through borrowings, some of the operating cash flow of the REIT will need to be applied for that purpose. This may deprive the REIT of sufficient cash flow to make the necessary distributions to maintain its REIT qualification and avoid corporate-level taxation. At the federal level, this problem is solved by making so-called consent dividends. When the REIT declares a consent dividend, the REIT is treated as if it distributed cash to its shareholders who then recontributed those amounts to the REIT.³⁰ This permits the REIT to make necessary deemed or actual distributions to avoid corporate-

³⁰ Consent dividends require shareholder consent and typically are not done for preferred shareholders.

level taxation, but at the cost of causing the shareholders to pay tax on phantom income.

But not all states recognize consent dividends. For example, California does not. As a result, a REIT operating in California would not qualify to deduct its consent dividends in computing its income subject to tax at the corporate level. Rather, actual distributions must be made by the REIT to the joint venture. It is best to consult state tax counsel to determine whether a given state recognizes consent dividends and whether that state would permit a deduction for the dividend paid if that amount is required to be recontributed to the joint venture.³¹ Where recontribution is necessary, care must be taken in drafting the distribution provisions of the joint venture so that the recontributed amount is excluded from the definition of cash flow that is required to be distributed.

A second issue advisors need to be aware of and to investigate is whether the states in which the REIT operates have any limitation on the dividends paid deduction for REITs that are owned by other entities (so called "SALT REITs").³² While it is not uncommon for the deduction to be denied where more than 50% of the REIT is owned by another entity, this denial of deductibility is most often limited to situations where the REIT is more than 50% owned by a corporation. In a few states, the existence of a noncorporate greater than 50% owner (such as the joint venture discussed above) will eliminate the dividends paid deduction and cause the Private DC REIT to be a state taxpayer.

The Education Process

Where a buyer suddenly finds itself facing the prospect to having to acquire REIT shares to gain control of an attractive real estate investment, it will need to become knowledgeable about what managing a REIT entails.

For example, REITs may not provide non-customary services to tenants or enter into leases providing for rents based on net (rather than gross) income. Parking, health clubs, cafeterias and lodging require special structuring. Failure to recognize when these rules may be violated can cause a REIT to fall out of compliance, a very costly affair.

³¹ Even if the REIT does not have sufficient funds to pay the consent dividend in cash, it may be able to invade its reserves to make the distribution, because the funds will be coming directly back to the REIT immediately after distribution.

³² For a discussion of a highly publicized SALT REIT structure, see Jesse Drucker, "Wal-Mart Cuts Taxes By Paying Rent to Itself," *The Wall Street Journal*, Feb. 1, 2007.

Experienced real estate investors who have used REITs in the past generally will have internal controls sufficient to ensure compliance, but investors without that experience will need to develop those controls and sufficient knowledge in the area to avoid the pitfalls.

At the outset, this is often handled by having an acceptable form of lease made a part of the joint venture documentation. Any lease departing from the model would require consent from the other partner or possibly the advice or opinion of tax counsel. This may slow the operator's ability to respond to tenant requests because of the additional layer of review, particularly where an outside tax advisor's judgment must be obtained.

CONCLUSION

Although co-investing with international investors in U.S. real estate is complicated, international investors have become an increasingly important capital source for U.S. real property investments. Clear advice on how the issues related to such co-investments play out in practice will be critical to making the investment successful for all parties.

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READERS' SUBMISSIONS INVITED

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