



REITs Always Make Sense (Except When They Don't)

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Introduction

- A quick review of the U.S. REIT rules is bound to make you feel like you've got a few roos loose in the top paddock. With a bit of hard yakka, though, you'll see that REITs can often put you on a good wicket
- Here in the Lucky Country, we know investors have been flat out like a pancake dropping hard-earned moolah on U.S. assets in the hopes of taking advantage of the REIT rules
- But using a REIT doesn't always mean that you're home and hosed. The REIT rules simply don't fit every situation. But, no drama -- she'll be right, mate. There are many ways to invest tax efficiently in U.S. real estate without using a REIT

Success of REITs

- REITs in the United States (introduced in 1960) have been wildly successful
- As late as 1994, only 3 other countries allowed REITs
 - As of 1/1/07, the U.K. has allowed REITs, bringing to 17 the number of countries with public REIT markets
 - 12 other nations have legislation in place or under consideration to create REITs (e.g., Germany is expected to offer REITs this spring)
 - Source: “A Coming of Age for the Global Real Estate Market,” The New York Times, January 7, 2007.
- Most non-U.S. REIT regimes are modeled to some extent on the U.S. regime
 - In general, real estate companies get favorable tax treatment in exchange for disbursing most or all of their income to shareholders
- Rapid expansion of REITs shows increasingly global nature of real estate investment
 - Investors are increasing their exposure to international real estate
 - U.S. REITs themselves are acquiring more foreign property or forging partnerships with foreign partners
 - For instance, more than 40 percent of ProLogis’s \$25 billion in real estate assets under management are outside North America.


General Principles

- A REIT is taxed as a corporation, but unlike an ordinary corporation, a REIT can deduct dividends paid to its shareholders in determining its taxable income
- Thus, REITs generally try to pay dividends in an amount that reduces taxable income to zero



Requirements for Being a REIT

- Taxable as a corporation
- Managed by a board of directors or trustees
- Transferable shares or equity interests
- At least 100 shareholders
 - Options for meeting this test include (i) selling shares through a third party service, (ii) employee investment, and (iii) distributing shares to employees as a bonus
- Not closely held: no more than 50% of equity interests held by five or fewer individuals during the last half of year)
- Asset tests:
 - At least 75% of REIT's total gross assets consist of real estate assets
 - Other 25% may be invested as desired, subject to certain limitations
- Income tests:
 - $\geq 75\%$ of gross income is rent on real estate property or mortgage interest
 - $\geq 95\%$ of its gross income is from the 75% "bucket," plus certain other types of passive income, such as dividends and interest
- Distribute at least 90% of its taxable income in the form of shareholder dividends
 - Practically, REIT should distribute 100% to avoid entity level tax



Benefits of REITs to Non-U.S. Investors

- Investing Directly in U.S. Real Estate Generally is Tax Inefficient:
 - Pay U.S. tax at a rate of up to 35% on income and gains, plus U.S. branch profits tax for corporations (at a rate of 30%, but reduced to 5% under the U.S.-Australia income tax treaty, or the Treaty)
 - File U.S. income (and potentially state) tax returns
 - No treaty protection

Benefits of REITs to Non-U.S. Investors

- REITs provide many advantages over direct investment
 - Rents are “converted” into ordinary dividend income, which in most cases is eligible for a reduced rate of U.S. withholding tax (from 30% to 15% under the Treaty)
 - In general, under the Treaty, an ordinary dividend paid by a REIT will be subject to a reduced rate of U.S. withholding tax (15%) if the beneficial owner of the dividend (i) is an individual that owns 10% or less of the REIT, (ii) owns 5% or less of the REIT and the REIT is publicly traded, or (iii) owns 10% or less of the REIT and the REIT is “diversified”
 - Thus, reduced withholding would not be available to a wholesale investor that owns more than 10% of the REIT in question
 - The dreaded “FIRPTA” tax: gains from the sale of REIT shares (unless the REIT is domestically controlled), and REIT dividends of gains from the sale of U.S. property, may be subject to 35% U.S. tax (and potentially branch profits tax)
 - No investor-level U.S. income tax return if investor receives only ordinary dividend income
 - No entity-level tax if dividends strip out 100% of taxable income



REIT Asset Tests

75% Gross Asset Test

- At the end of each quarter of its taxable year, 75% of a REIT's gross assets must consist of (among other things):
 - Interests in real property
 - Interests in mortgages on real property
 - Shares in other REITs
 - Cash and cash items (including receivables)
 - Government securities
 - Qualified temporary investments of new capital (e.g., IPO proceeds)

Other Asset Tests

- The other 25% of a REIT's assets (i.e., assets other than the real estate assets described above) generally may be invested without restriction, subject to three additional tests:
 - Not more than 5% of the REIT's total assets may be represented by securities of any single non-government issuer, other than a qualified REIT subsidiary (a QRS) or a taxable REIT subsidiary (a TRS)
 - Note: a TRS is an affiliate of the REIT that is fully subject to tax and that engages in activities or services that a REIT is precluded from undertaking
 - Not more than 20% of the value of a REIT's total assets may be represented by securities (including debt) of one or more TRS
 - A REIT may not own securities representing more than 10% of either the vote or value of the outstanding securities of any issuer (other than another REIT, a TRS, or a QRS)
- Where a REIT invests in an entity treated as a partnership for tax purposes, the REIT is treated as owning a proportionate share of the entity's assets.



REIT Income Tests

75% Gross Income Test

- At least 75% of a REIT's gross income for the taxable year must consist of:
 - rents from real property, with certain exceptions (discussed below);
 - interest on obligations secured by mortgages;
 - dividends from, and gains from the sale of, shares of REIT stock;
 - income from the operation of, and gain from the sale of, “foreclosure property”;
 - certain qualified temporary investment income from investment of new capital; and
 - gain from sale of any other real estate asset that is not a “prohibited transaction” (generally dealer-type transactions)
 - A REIT that sells dealer-type property (for example, land subdivisions or condominiums) will be subject to a 100% tax on any gain from such sale or disposition
 - Income from hedges on debt incurred to acquire real estate is subject to special rules (in general, though, hedging should be done outside the United States)



95% Gross Income Test

- At least 95% of a REIT's gross income for the taxable year must consist of:
 - Income qualifying for the 75% test;
 - Dividends (including dividends from a TRS);
 - Interest; and
 - Gains from the sale or disposition of stock or other securities that are not dealer property.
 - Income from hedges on debt incurred to acquire real estate is ignored for purposes of this test
- 5% Bad Income Bucket: In other words, a REIT may receive up to 5% of its annual gross income from sources that do not qualify for either the 75% and 95% income tests
- Annual Testing: Because the income tests are required only on a yearly basis, and because it is more difficult to “cure” a failure (or anticipated failure), most REITs make at-least quarterly income projections and perform quarterly income testing

Income Tests - Issues

- Related Party Rents

- A REIT may not enter into a lease with a tenant that is more than 10% owned by:
 - the REIT, or
 - a person who owns more than 10% of the REIT
- Attribution rules apply when determining ownership for this purpose
- Certain limited exceptions apply in the case of leases to a TRS of a REIT



Income Tests - Issues

- Income “No-nos”

- Interest received by a REIT may not be based on the borrower’s net income (interest based on gross income is permissible)
- A REIT may not enter into a lease where more than 15% of the rent is attributable to the rental of personal property (e.g., furnishings, appliances, equipment)
 - If the rent attributable to personal property exceeds 15% of the total rent for the lease for a taxable year, then none of the rent attributable to the personal property qualifies as “rents from real property”
- A REIT generally may not provide non-customary services (e.g., maid service) to any tenant, other than through an independent contractor or a TRS. If such services are provided by a REIT, the income attributable to such services (including income not separately charged) cannot exceed 1% of the REIT’s income from the property
- The REIT rules generally are more flexible than the Division 6C limitations

Income Tests - Issues

- Special Property Types

- Parking Garages

- A REIT may not operate a stand-alone parking lot or facility as such operations would not generate REIT qualifying income. Instead, a REIT may lease the parking lot or facility to a third party operator
 - However, a REIT may operate a parking garage as part of its ownership of a building provided the REIT provides no services other than maintaining, repairing, and lighting the parking facilities, and other than those provided by an independent contractor
 - Recurring functions unique to the reserved spaces (such as enforcement) must be provided by (i) an independent contractor from whom the REIT does not receive any income (ii) or a TRS



Income Tests - Issues

- Special Property Types (cont'd)

- Hotels – benefit from special rule

- A REIT may not operate a hotel or other lodging facility. Instead, a REIT may either (i) lease the lodging facility to a TRS and have the TRS engage an independent contractor to operate the lodging facility or lease the lodging facility to a third party operator
- Tax leakage is limited

- Health Care Facility

- A REIT may not operate a health care facility (including senior/assisted living facilities). Under current law, a REIT must lease the health care facility to a third party operator
- Independent living facilities might be permitted – highly fact dependent
- A proposal has recently been introduced to change this rule to conform the treatment of such facilities to that for hotels (described above)



Miscellaneous REIT Requirements and Issues

90% Distribution Requirement

- A REIT must distribute at least (i) 90% of its taxable income less (ii) any excess noncash income
 - In general, REITs want to distribute at least 100% of taxable income to avoid any tax
 - Consent dividends (i.e., non-cash dividends) may be used to manage cash



Recordkeeping and Reporting

- Shareholder demand letters – annual requirement
- Formal documentation of transactions between a REIT and a TRS
- REITs are required to be calendar year taxpayers
- File U.S. federal (and possibly state) tax returns (and schedules thereto) on March 15 following the end of a taxable year
 - Six-month extensions generally may be obtained
- Any capital dividends must be properly designated and reported to shareholders
- File information returns with the IRS and its shareholders regarding dividends and withholding, if any

Deal Considerations

- REIT Questionnaires
 - Consider completing and reviewing a REIT questionnaire for each property prior its acquisition to ensure that such acquisition will not disqualify the REIT
- Given the importance of maintaining REIT status, pre-deal due diligence, and post-deal vigilance and monitoring, is critical
- Please note, however, that there are liberal “cure” provisions for foot-faults



Basic REIT Structures

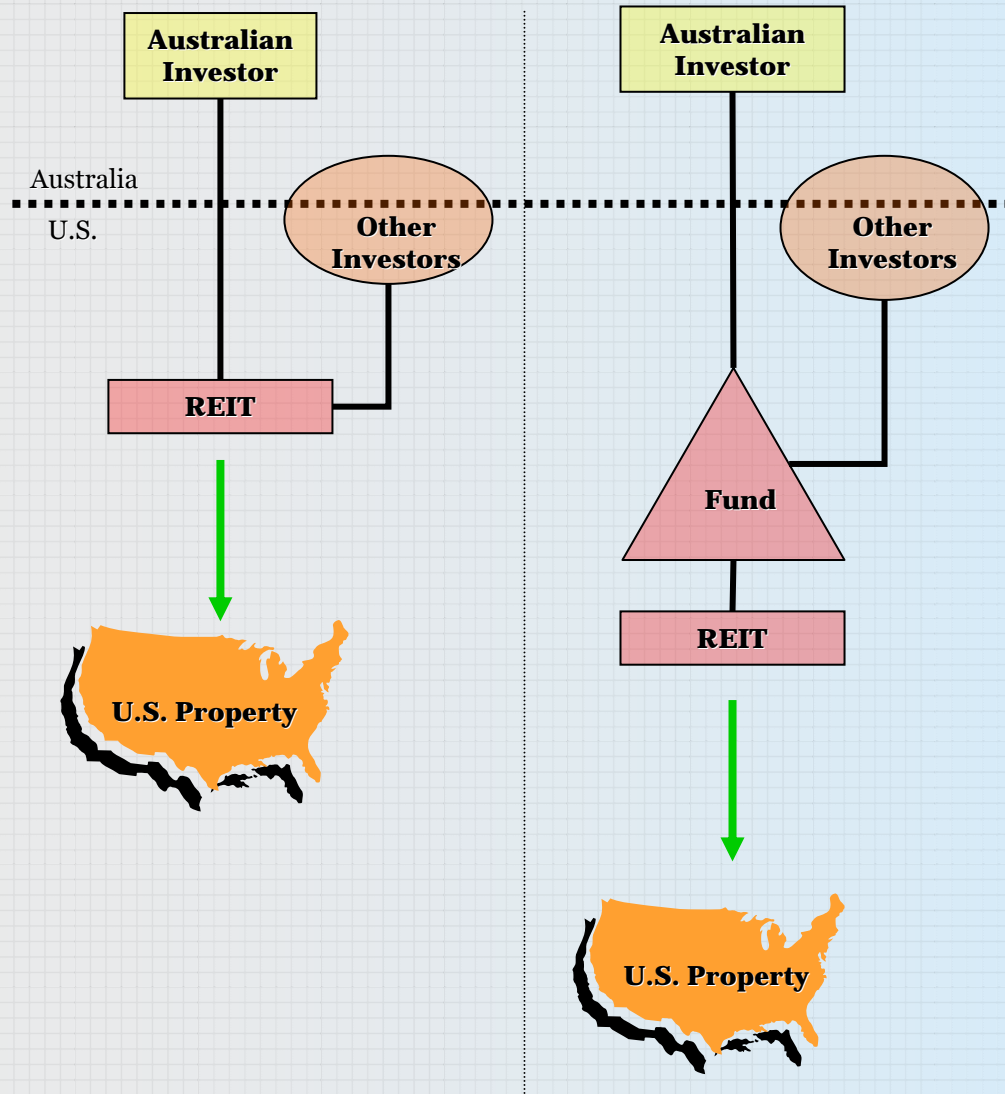
Direct Investment/Fund-Owned REIT

- Advantages

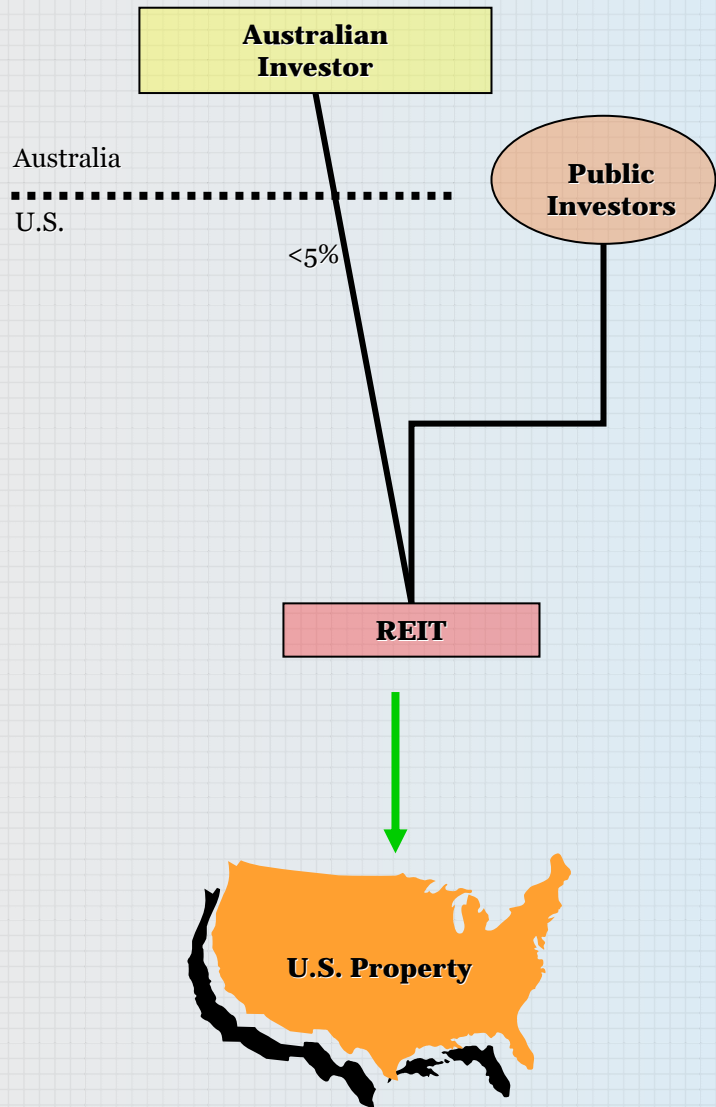
- Rental income is “converted” into dividend income
- Under the Treaty, w/h tax on ordinary dividends generally will be 15% (provided the investor owns less than 10% of the REIT); LPTs have a special rate under the Treaty (see below)
- Effective W/h Tax Less than 15%. Because dividends generally will be in amount in excess of earnings and profits of the REIT (such excess being a return of capital for U.S. tax purposes), the effective rate of tax on dividends generally will be lower than 15%

- Disadvantages

- REIT dividends of gains from the sale of U.S. property subject to 35% withholding tax (FIRPTA tax)
- Gain from sale of REIT shares or interests in Fund subject to 35% tax (FIRPTA tax), unless REIT is domestically controlled

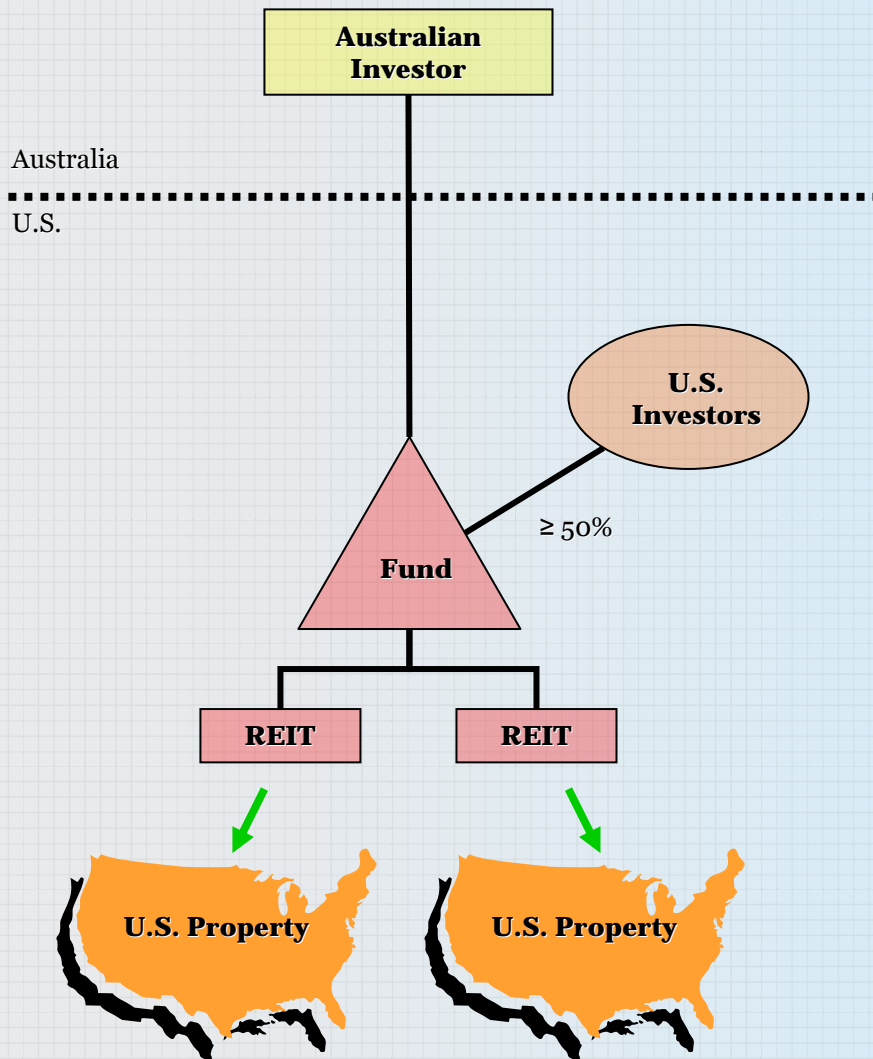


Publicly Traded REIT



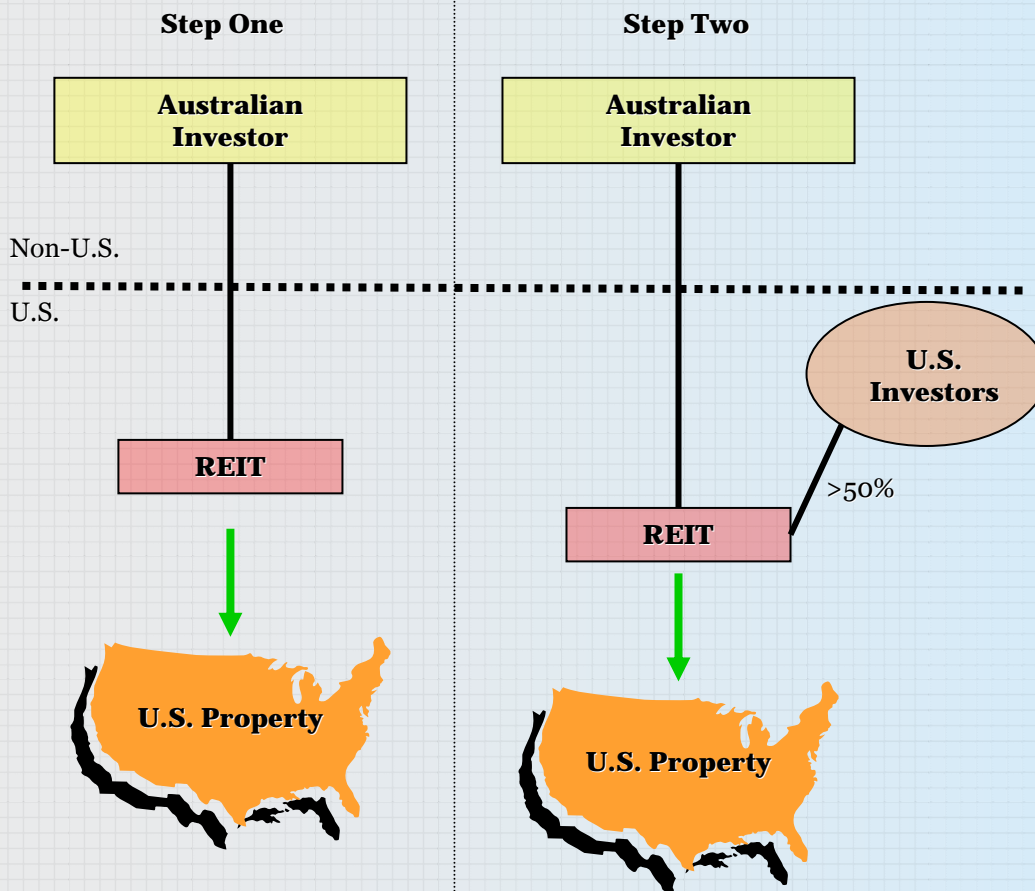
- Sales of shares not subject to FIRPTA tax if shares are held by a less than 5% owner (or if REIT is domestically controlled)
- Rental income (or interest income in the case of a “mortgage REIT”) is “converted” into dividend income
- Less-than-5% owner eligible for lower dividend withholding rate (15%) for capital gain dividends
- No U.S. tax return

Domestically Controlled REIT Fund



- Rental income is “converted” into dividend income
 - Under the Treaty, w/h tax on ordinary dividends generally will be 15% (provided the investor owns less than 10% of the REIT)
 - As noted above, the effective rate of tax on dividends generally will be lower than 15%
- No U.S. tax on sale of interests in Fund because REIT is domestically controlled
- Fund sells assets through sale of REIT stock: as a result, no U.S. capital gain tax is due
- No U.S. tax return for AU investors
- Overall effective U.S. tax rate on income and gains can be less than 10%, depending on investment profile

Become Domestically Controlled in Future

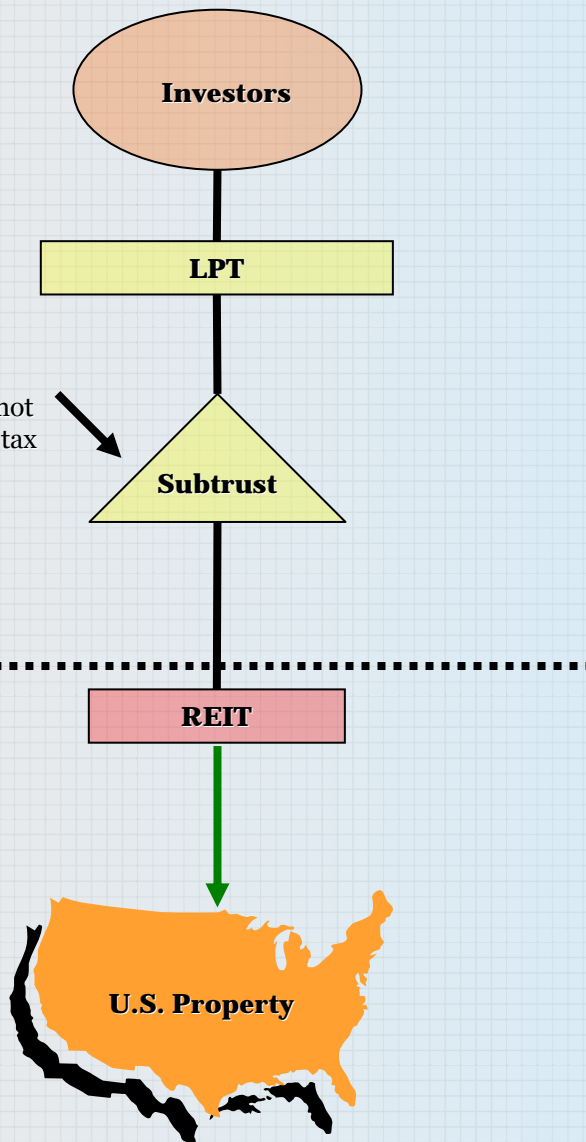


- In Step One, AU investor owns 99.9% of a REIT
- In Step Two, the REIT admits a U.S. person as >50% owner
- If the AU investor (or any other non-U.S. investor) waits five years, the REIT will qualify as domestically controlled, at which point it may sell its interests in the REIT without U.S. tax



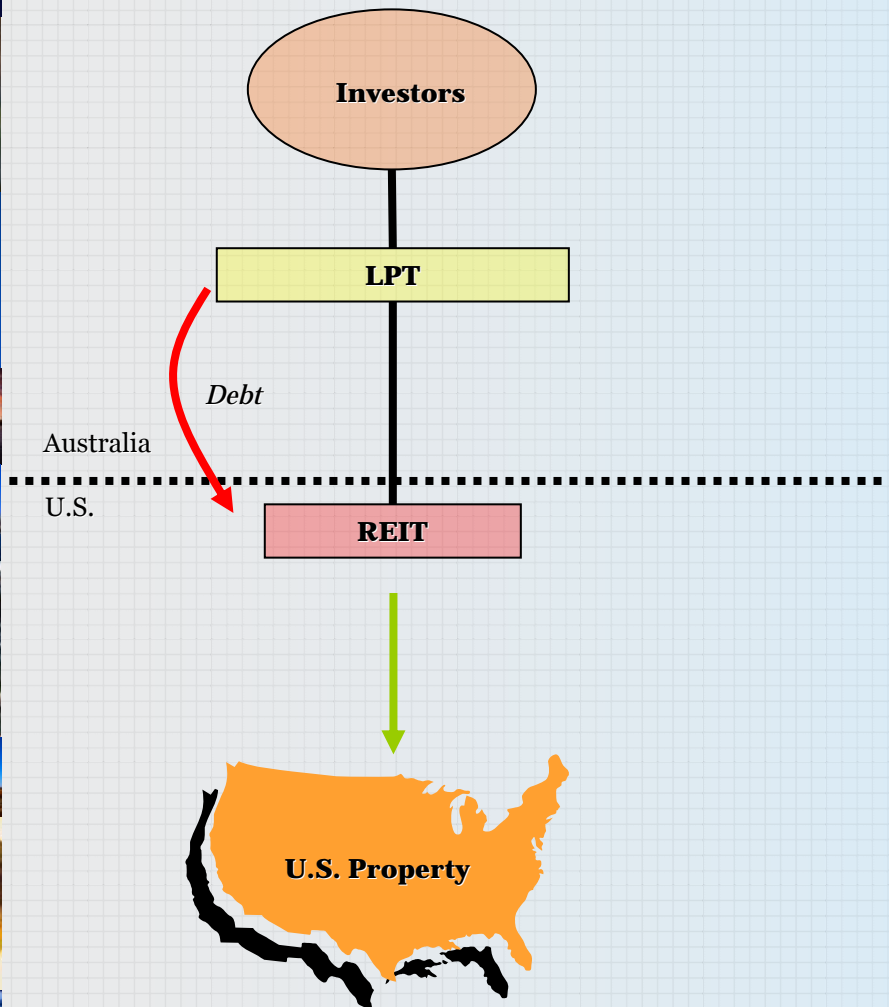
REIT Structures (Public/LPT Funds and Wholesale Funds)

Basics



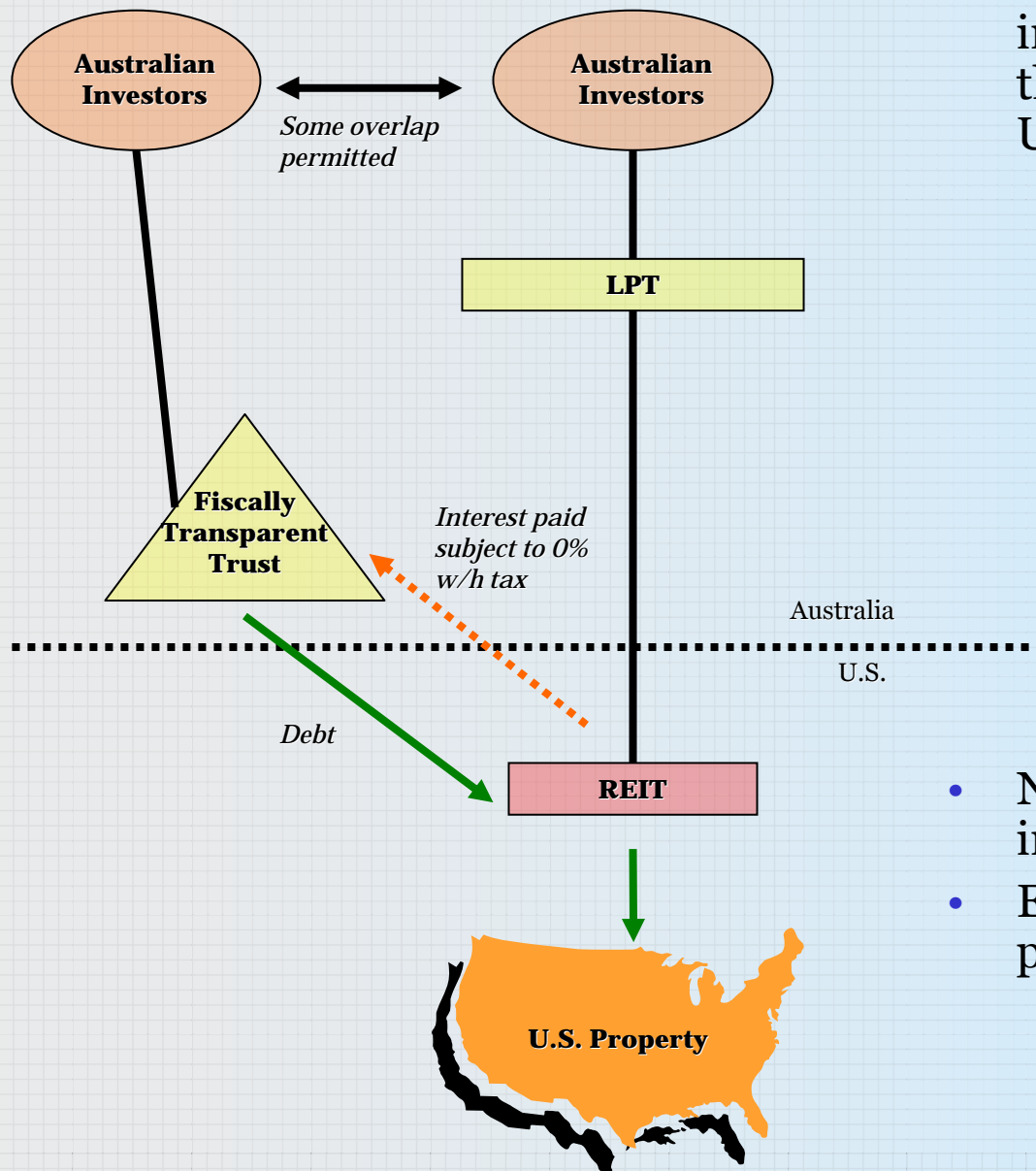
- Ordinary dividends: 15% U.S. w/h tax
 - Beneficial owners of LPT units that own 5% or more of the LPT may have 30% withholding tax, unless they are AU residents and otherwise qualify under the Treaty
 - Subtrust must be treated as fiscally transparent to claim 15% w/h tax
 - Easy to accomplish, but must be done before dividend is paid
- Non-AU investors can obtain these benefits, provided they own less than 5% of the LPT
- No U.S. tax on sale of interests in LPT
 - LPT retains the built-in U.S. tax (FIRPTA tax) -- i.e., the amount of the FIRPTA tax is transferred to the LPT's continuing investors
- Investors not required to file U.S. tax return on cash flows or sales

Debt and Equity Capitalization



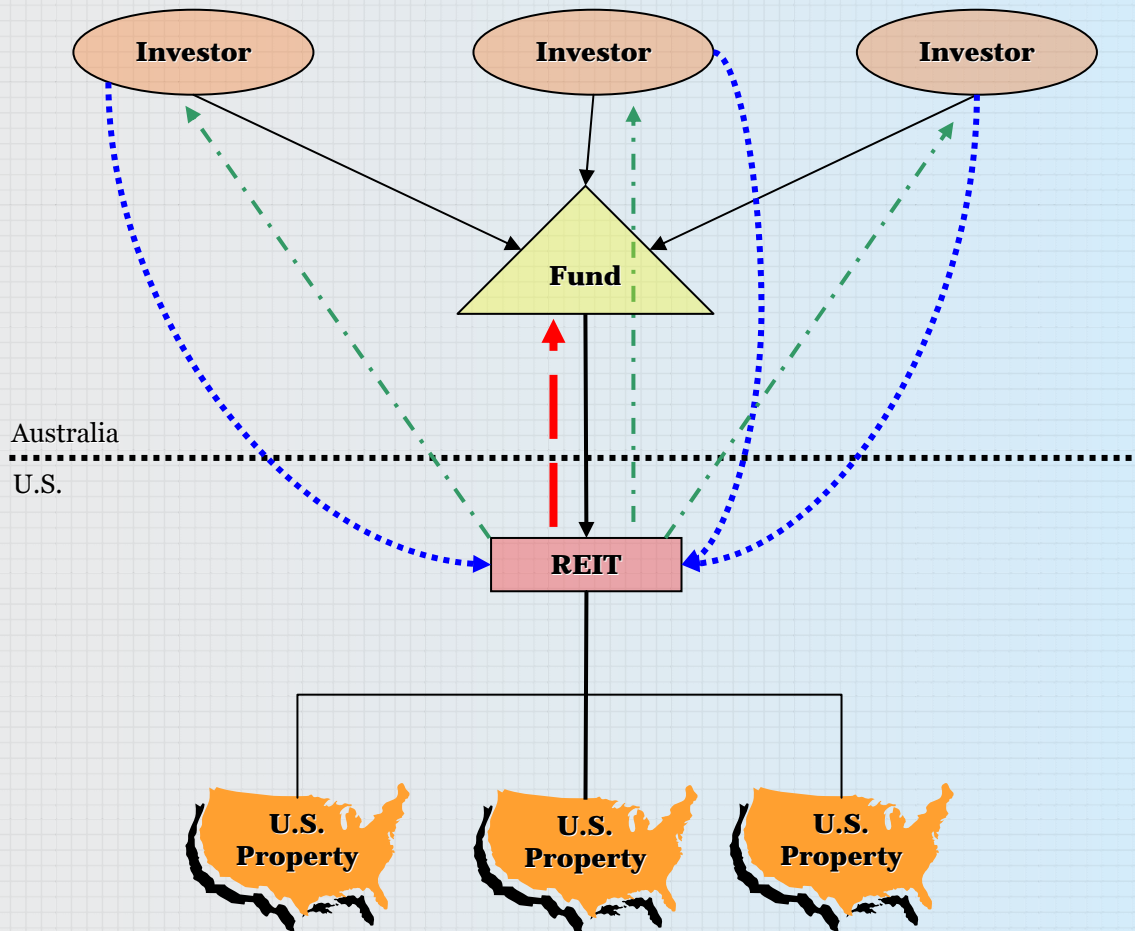
- Use of debt allows earnings to be distributed at a lower 10% withholding rate (versus 15% withholding on ordinary dividends)
- Interest payments reduce taxable income, and therefore amount of income that must be distributed in dividend form.
- Earnings stripping rules may limit the amount of interest that may be currently deducted
 - Rules apply only to related party interest expense; true third party interest is not restricted under these rules
 - Rules apply if REIT's debt-equity ratio exceeds 1.5:1 and the REIT's total interest expense exceeds 50% of EBITDA

"Super" Debt Structure

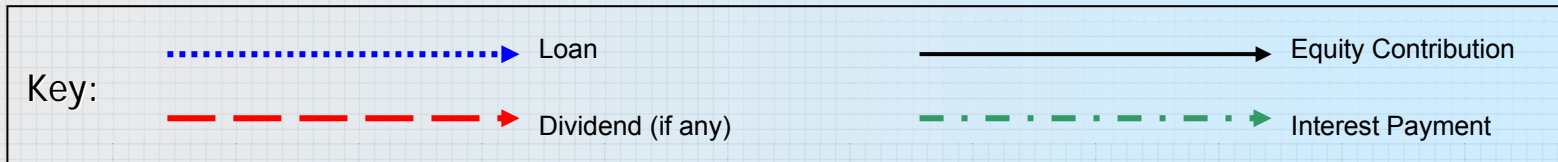


- With correct structuring, interest on REIT debt paid to the trust can be paid without U.S. withholding tax
 - The trust makes an election to be treated as a partnership for U.S. tax purposes
 - Interest paid to trust that is allocated to the unitholder in the trust that owns 10% or more of LPT will incur 10% U.S. withholding tax
 - Certain attribution rules apply for this purpose
 - Documentation is necessary to monitor the 10% ownership threshold
- No U.S. tax on sale of interests in the trust
- Earnings stripping rules potentially apply

Direct Investor Debt Structure



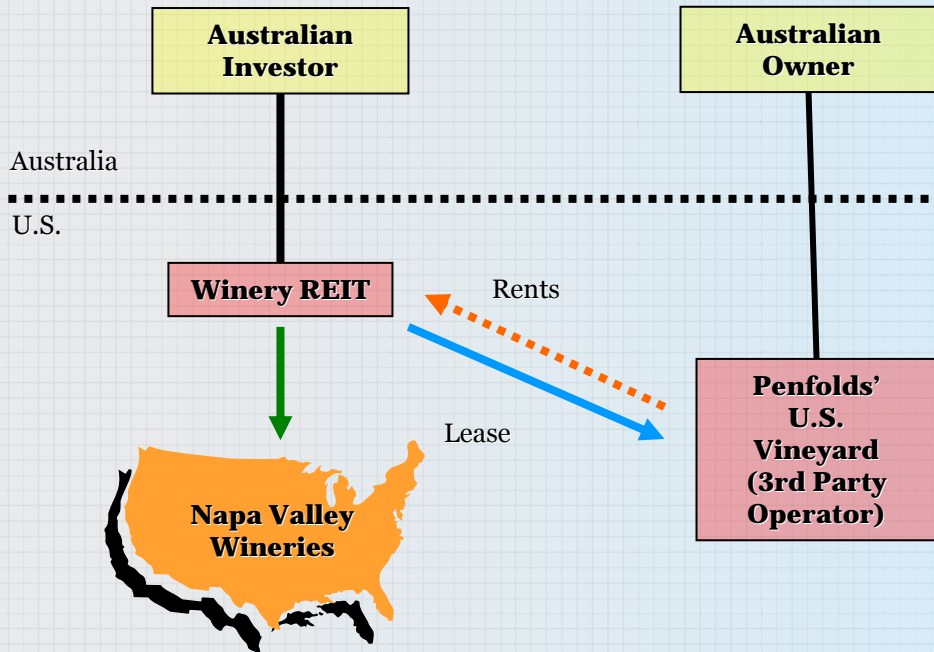
- REIT's net income reduced by interest payments (earnings stripping rules should not apply, provided no investor treated as owning $\geq 50\%$ of REIT)
- No U.S. w/h tax on interest, provided investor beneficially owns less than 10% of REIT (10% U.S. w/h tax otherwise for AU residents)
- Any remaining net income that is distributed subject to 30% U.S. w/h tax (although potentially reduced to 15%); capital gain dividends subject to 35% U.S. w/h tax (or potentially 15% if investor is individual or trust for U.S. tax purposes)





REIT/Operating Company Structures

General

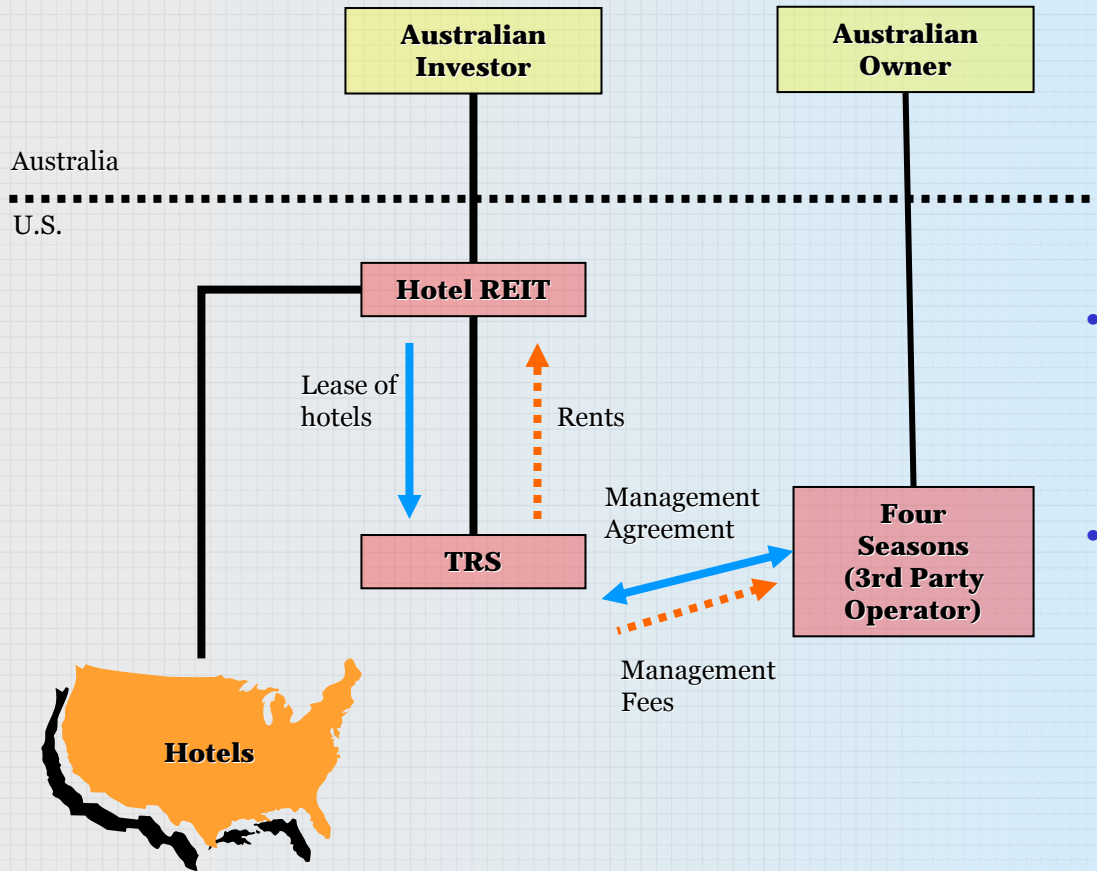


Properties for which this strategy may be useful include, among others:

- Wineries
- Car dealerships
- Parking lots
- Theme parks
- Senior housing

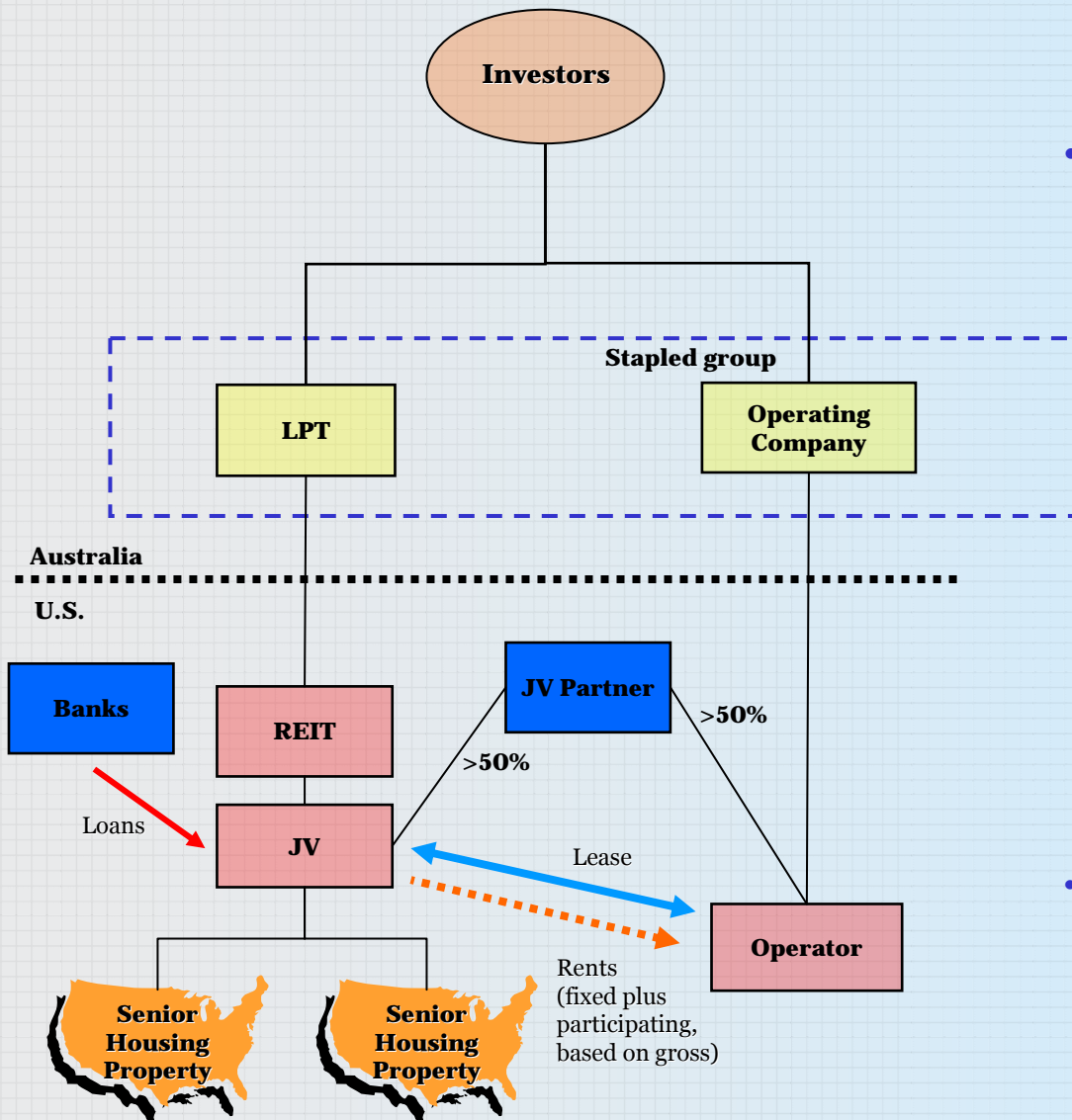
- Assets need to be “REITable”
- Lease strategies can potentially be used to make assets REITable
- Can be structured to give Australian investors ownership interest in operator (subject to REIT related party rent rules and potential Australian limitations)
- Goal is to maximize rents paid to the REIT (which are not taxable at the REIT level) to the extent permitted under U.S. tax laws
- Critical to justify rents in lease

Hotel REIT



- A REIT may not operate a hotel or other lodging facility.
- Owing to a special rule, a REIT may either lease the hotels to (i) a TRS and have the TRS engage an independent contractor (e.g., Four Seasons) to operate the lodging facility or (ii) a third party operator
- Can be structured to give Australian investors ownership interest in operator (subject to certain limitations)
- Leakage
 - Corporate tax on TRS's net income – any after-tax income from the lease is kept by the REIT
 - Management fees
 - W/h tax on dividends and/or interest

Ownership of Operator

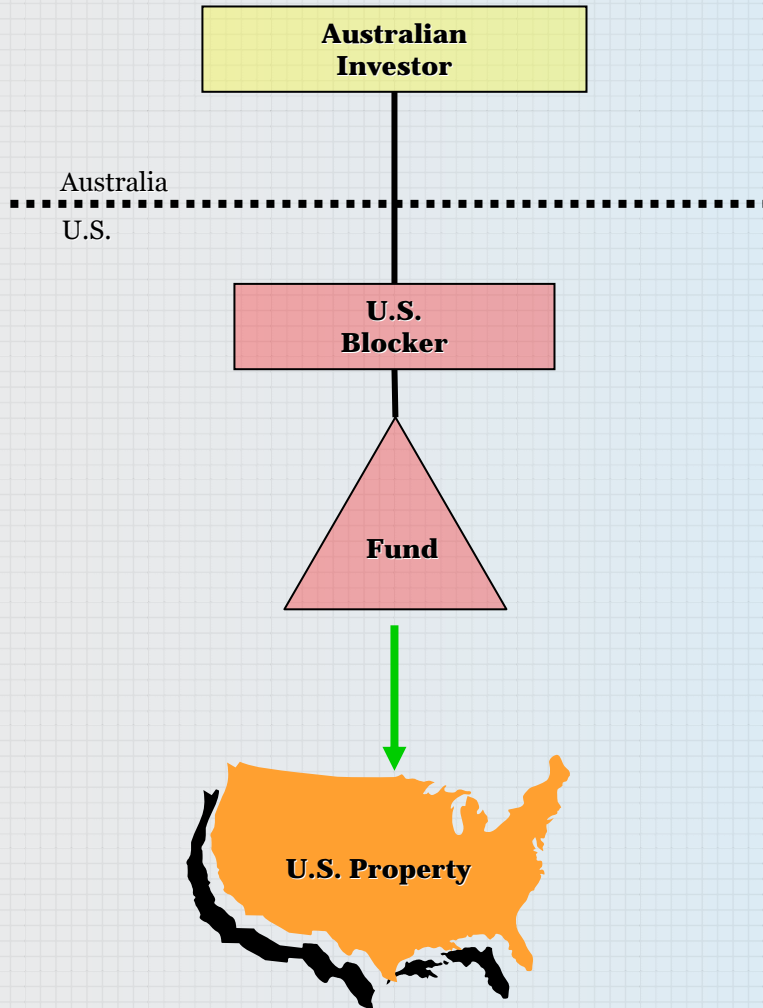


- Senior housing assets that otherwise would not be “REITable” under current law made REITable through lease to operator
- Because the Australian investing entities are stapled, there is a material risk that the IRS would treat the operator and the REIT as related for purposes of the REIT related party rent rules
 - To obviate this risk, AU investors should be limited to <50% interest in JV and operator
 - Continued monitoring of JV ownership levels necessary to avoid related party rent rule issues
- **Increased ownership of operator by LPT or AU investing entities would require the use of alternative structures (for instance, direct investment) to minimize tax**



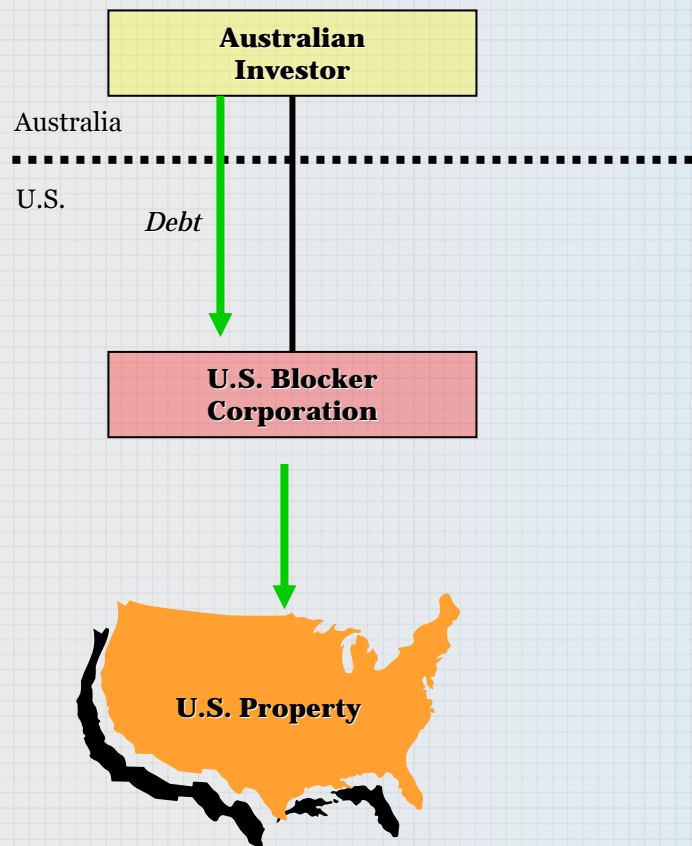
Non-REIT Blocker Structures

Basics



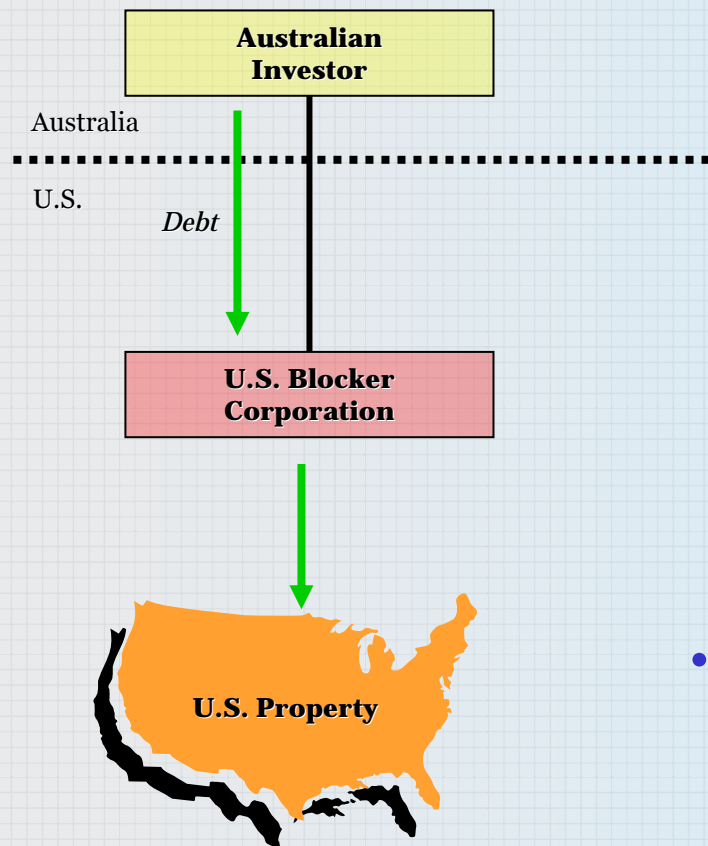
- Advantages
 - Investor entity need not file a U.S. tax return
 - No branch profits tax
- Disadvantages
 - Up to 35% tax on Blocker income
 - 15% withholding tax on dividends
 - 5% for Australian company with $\geq 10\%$ ownership
 - 0% for Australian public company with $\geq 80\%$ ownership after holding for one year
 - Any withholding tax makes investment through a blocker (without debt structuring or credit for U.S. taxes) less efficient than direct ownership
 - Credit for U.S. withholding tax may be available
 - Exception from withholding if U.S. property sold and Blocker liquidates

Debt and Equity Capital



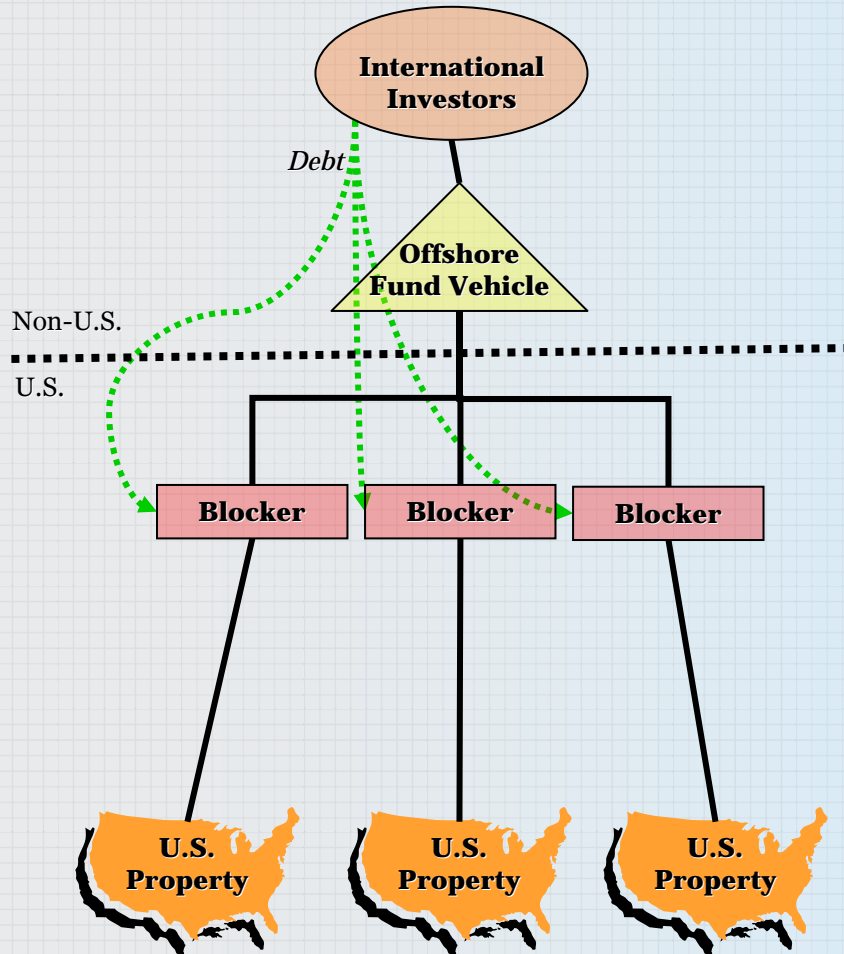
- Reduced net effective corporate income tax
- If debt is properly structured for U.S. tax purposes, 10% U.S. withholding tax on interest
 - Potentially reduced to 0% withholding under “portfolio interest” exemption
 - In order to qualify for this exemption, Australian investor cannot own 10% or more of the voting stock of the U.S. Blocker Corporation
- Earnings Stripping Limitation. Note, however, that earnings stripping rules may cause deduction for some current interest expense to be deferred
 - Rules apply only to related party interest expense; true third party interest is not restricted under these rules
 - Rules apply if blocker’s debt-equity ratio exceeds 1.5:1 and the blocker’s total interest expense exceeds 50% of EBITDA

Cleansing Rule



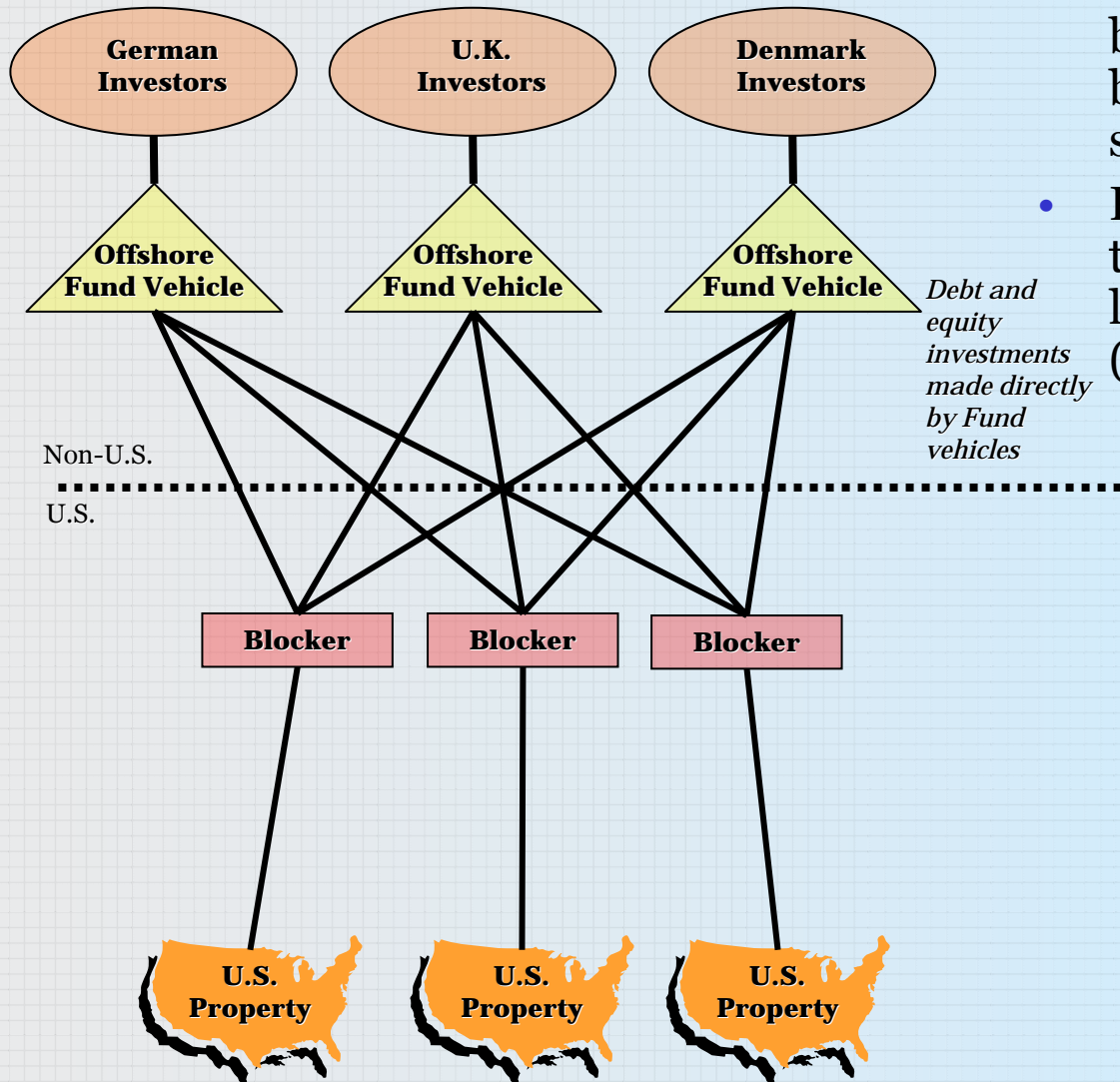
- Advantages
 - Instead of making dividend distributions, blocker retains earnings until property is sold or earnings paid out in the form of interest or repayment of principal
 - Once property is sold, blocker can be liquidated, and retained earnings may be distributed without U.S. withholding tax
- Disadvantages
 - Any dividend distributions made before liquidation of blocker reduce the benefit of the cleansing rule

Blocker/Debt Fund Structure



- Combines many of the advantages of the blocker/debt structure outlined but applies it to multiple properties
- Offshore fund vehicle may establish a new blocker to hold each separate investment to permit liquidation of blocker in respect of a single investment
 - The goal is to avoid U.S. withholding tax on payments of the proceeds from the sale of each asset
- Investors commit to investing via debt directly to the US blockers and equity into the offshore fund vehicles
 - No investor may own more than 10% of the offshore fund vehicle, in order to obtain 0% U.S. withholding on interest payments under portfolio interest exemption
 - Such restriction also ensures that earnings stripping rules will not apply (because no investor owns 50% or more of vehicle)
 - 0% withholding on payments of the proceeds from the sale of each asset
 - 0% withholding on interest payments

Blocker/Debt Global Fund Structure

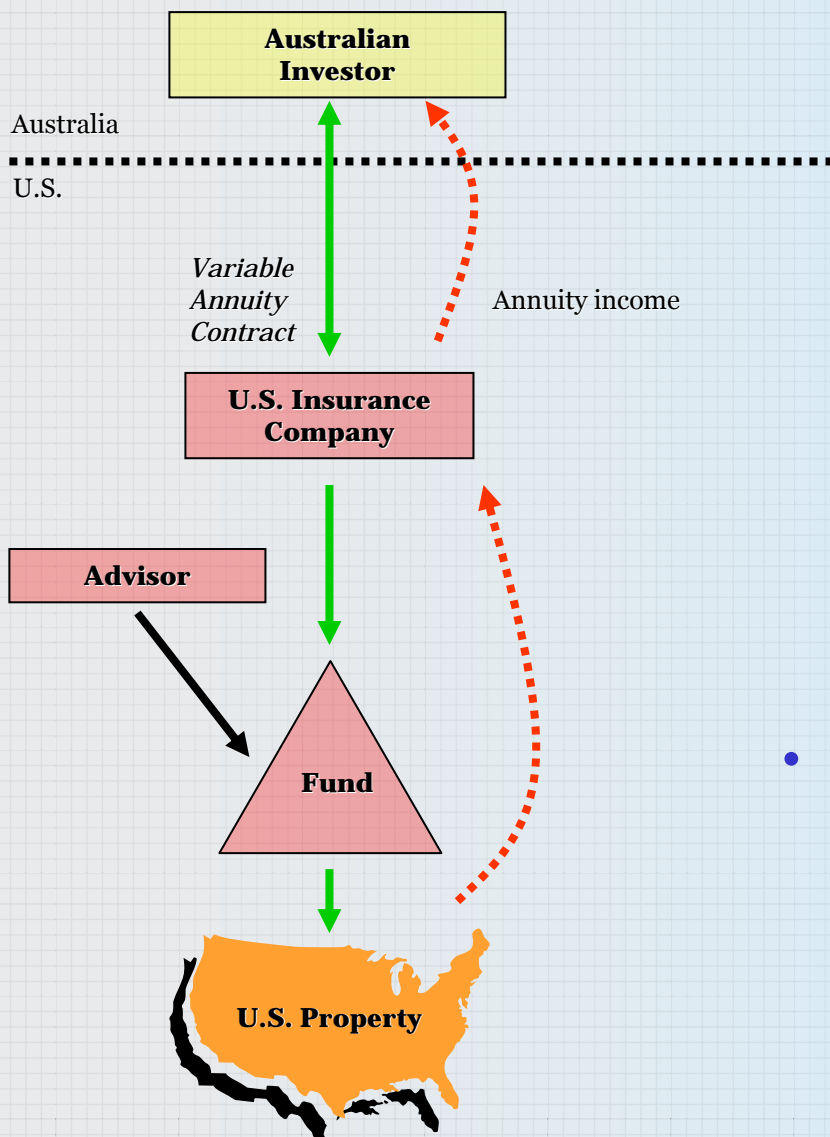


- Largely the same benefits of the blocker/debt fund structure outlined above
- Primary difference is that fund vehicles may lend directly to Blockers (greater simplicity)
 - No offshore fund vehicle can own 50% or more of a Blocker (in order to avoid earnings stripping rules)
 - No investor (looking through the offshore fund vehicles) can be treated as owning 10% or more of a Blocker in order to qualify for the portfolio interest exemption from U.S. withholding tax on interest payments made by such Blocker



Other Structures

Separate Account – Basic Structure



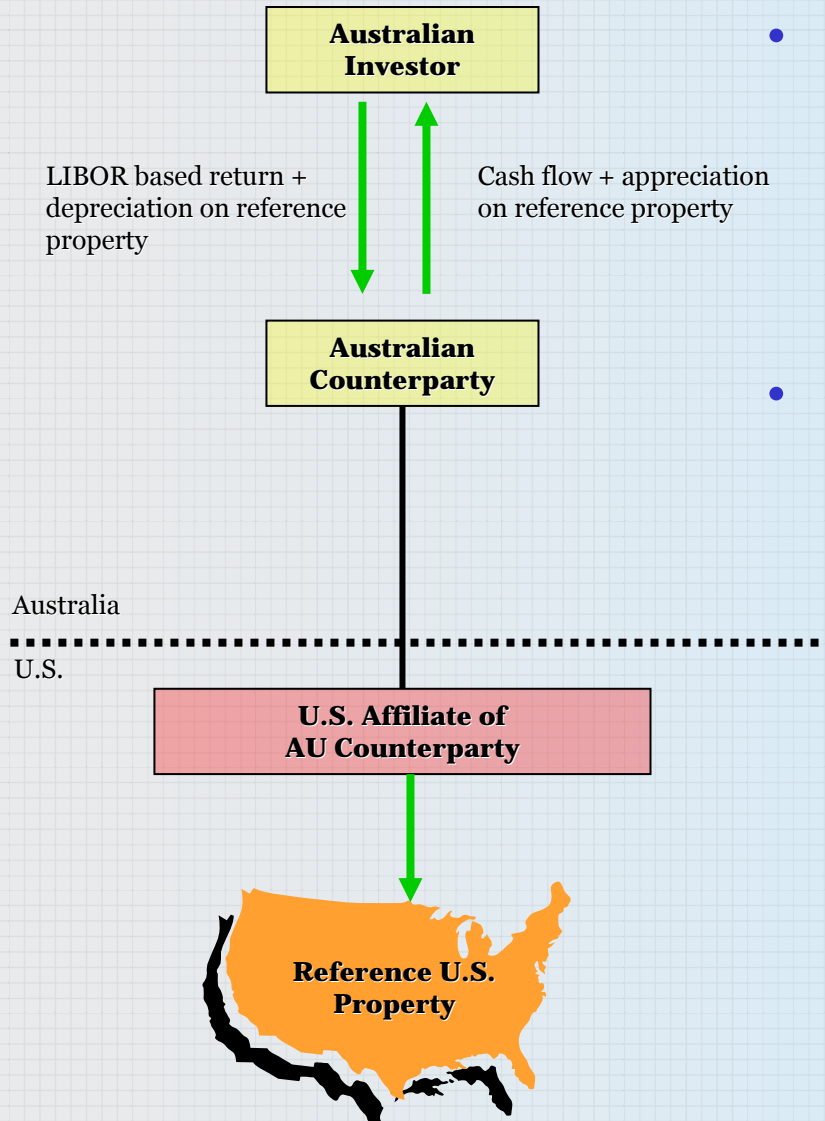
- Advantages

- Insurance company treated as tax owner of U.S. property
- Annuity income received by individuals not subject to U.S. tax under Article 19 of Treaty
 - Annuity income received by Australian non-individuals may be tax-free under Article 21 of Treaty as “other income”
 - Annuity income received by Australian government likely not subject to U.S. tax under U.S. statutory rules

- Disadvantages

- Investor has no right to control investment by Fund
- Assets cannot be treated as “publicly available”


Derivative Contract – Total Return Swap



- Advantages
 - No direct ownership of U.S. property
 - Swap payments generally not subject to U.S. withholding tax
- Disadvantages
 - Tax ownership question not settled
 - Market not robust
 - Pricing difficult
 - No control over property



Hot Topics



U.S. Investors – PFIC Concerns

- Many questions about this in the past year
- PFIC (Passive Foreign Investment Company): a foreign corporation if either (i) $\geq 75\%$ of gross income for the taxable year is passive income (such as dividends, interest, rents) or (ii) $\geq 50\%$ of the value of its assets produce passive income
 - LPTs likely to be treated as PFICs
 - *PFIC rules are an issue for U.S. investors in LPTs (or any other foreign entity) whether or not the LPT (or other entity) owns U.S. assets*
- These rules apply regardless of the level of U.S. ownership
- Without a qualified electing fund (“QEF”) election, a U.S. shareholder of a PFIC that receives an “excess distribution” (basically, an historically disproportionate dividend) from the PFIC or transfers its PFIC stock, pays U.S. tax at the top ordinary income tax rate (not capital gains rate), plus an interest charge to reflect the value of deferral
- With a QEF election, a U.S. shareholder includes in income a pro rata share of the PFIC’s earnings (whether or not distributed)
 - The foreign corporation, in turn, must agree to provide information regarding its earnings, calculated under U.S. principles

Convert 35% FIRPTA Tax to 15% Tax?

- Dutch pension plans have received rulings to the effect that they are trusts for U.S. federal income tax purposes
- As a result, they qualify for non-corporate U.S. tax rates (15% rather than 35%) on long-term capital gains from the sale of real estate (i.e., FIRPTA gain)
- It may be possible for certain Australian trusts (such as superannuation funds) to obtain such rulings/certificates
 - Whether an arrangement will be treated as a trust depends on whether it can show that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. These are admittedly vague standards, the application of which is highly fact specific



Thank you.
Hooroo.



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