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cutting through complexity

Unlocking the Value Hidden in Real Estate Holdings

REIT Conversion Benefits

Introduction

While real estate investment trusts (REITs) have long provided property owners an efficient operating structure, more companies are now rethinking how to uncover additional value from their real estate assets via REIT conversion.

Traditional REIT investments typically include properties such as retail centers, office buildings, warehouses, hotels and apartment buildings. However, businesses that don't conform to these traditional categories are seizing innovative opportunities to convert to a REIT structure based on other income-producing properties such as timber, casinos, storage facilities, cell towers, billboards and other infrastructure assets.

Although the benefits of operating as a REIT can be attractive—including access to additional sources of capital—the decision to convert to a REIT structure should only be made after the careful consideration and analysis of a wide range of factors. The rules governing taxation and qualification of REITs are complex, and REIT conversions may require significant changes in the business plan of an organization. Therefore, it is critical to ask the right questions in order to determine whether operating as a REIT is in strategic alignment with your company's long-term business goals.

This paper offers a brief introduction to REITs, provides an overview of several options for converting to a REIT structure, and highlights the requirements and potential benefits and challenges for companies and their investors. It also includes key questions to ask when considering a REIT conversion.

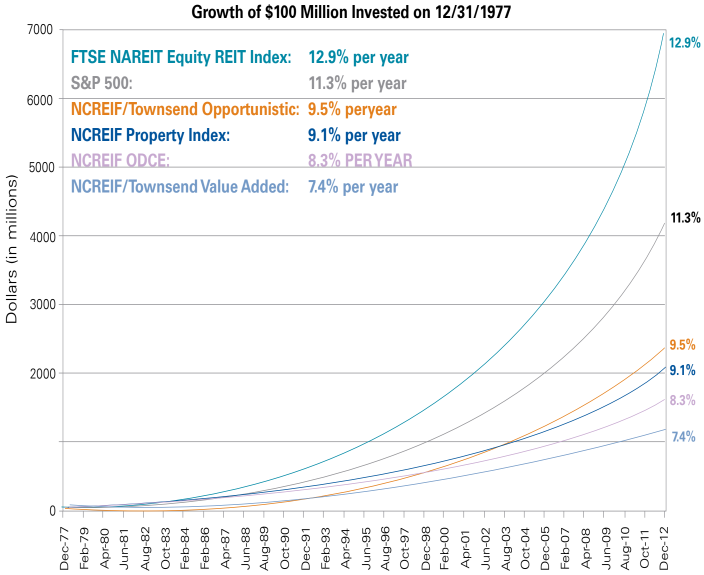
The Rising Popularity of REITs

Real estate investment trusts (REITs) have been raising capital in public markets for investment in real estate since 1960. The benefits and successes of REITs are well proven and have increased over the years. Recently, interest in more innovative uses of the REIT structure has increased, particularly with nontraditional assets as a way to capitalize on taxation and other benefits provided by the structure.

Key figures for REITs[1]

US$1 trillion:	Amount of real estate held in REITs
US$600 billion:	Equity market cap of 160 REITs traded on the New York Stock Exchange
1 million:	Number of U.S. jobs supported by REITs through operations and facility use
300:	Number of REITs currently registered by the SEC
40,000:	Number of commercial properties owned by REITs

REITs versus other real estate equity investment vehicles



Source: http://www.reit.com/REIT101/REITAttributes/InvestmentPerformance.aspx

1 NAREIT, the National Association of Real Estate Investment Trusts, accessed at reit.com

What is a REIT?

A REIT is an ownership structure approved in the U.S. tax code for investments in real estate. Modeled after mutual funds, REITs provide average investors the ability to invest in investment-grade commercial real estate, enabling them to buy dividend-paying stock in companies with large real estate holdings. In 2012, REITs paid out approximately US$29 billion in dividends, and 50 million Americans now invest in REITs individually and through their 401(k)s.[2]

Corporations that own significant amounts of real estate—or require a significant investment in real estate assets—must necessarily incur a heavy cost of capital in carrying these assets on their balance sheet. The REIT structure provides a means of securitizing real estate assets, and allows owners to divest their real estate assets to managements that specialize in owning and operating real estate.

For investors, REIT stocks are potentially attractive for several reasons:

Performance

REITs have historically offered strong long-term total returns. From January 1978 through December 2012, equity REIT performance exceeded both the broad equity market and other forms of real estate investment by more than 1 percentage point per year, producing an average annual return of nearly 12.9 percent[3].

Income

REITs generally tend to generate a stable and consistent income stream for investors. From 1972 through 2012, REITs yielded a consistent annual income component of 8.09 percent, representing approximately 60 percent of the industry's average annual total return of 13.72 percent[4].

Inflation protection

Real estate has traditionally provided a natural protection against inflation because rents have tended to increase when prices do.

Diversification

REITs offer a strong complement to direct investment in real estate. By taking advantage of both public and private investment in real estate, investors can take advantage of a broad continuum of investment options for their real estate allocations.

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[2] Ibid.

[3] Ibid.

[4] Ibid.

Liquidity

Investors find it easier and more efficient to invest in real estate through REITs due to REITs' market liquidity. The equities of companies that own portfolios of properties or engage in real estate financing are bought and sold on major U.S. stock exchanges, thereby offering investors exposure to commercial real estate while mitigating the risk of illiquidity.

Transparency

Listed REITs provide operating transparency because they are registered and regulated by the SEC, which requires listed entities to meet high standards of corporate governance, financial reporting and information disclosure.

REITs also provide a way to own real estate that results in a single layer of taxes, similar to real estate owned directly or through partnerships. For example:

- A REIT is generally subject to tax rules applicable to corporations, so its shareholders are not ordinarily treated as engaged in the business activities of the REIT.
- A REIT is entitled to a deduction for dividends paid, so it is not ordinarily taxed on income currently distributed to its shareholders.

Under this treatment, taxable income from a real estate asset before a REIT conversion might be subject to a 35 percent federal tax at the corporate level. After a REIT conversion, generally no tax is paid at the REIT level, provided dividends are equal to or exceed taxable income. However, unlike other corporations, a REIT must distribute virtually all of its taxable income as dividends; the taxes paid by shareholders on these dividends are at the ordinary income rate rather than at the qualified dividend rate. Thus, the overall taxation of the REIT and its shareholders is generally the same as the overall taxation of a partnership and its partners, with the caveats that REITs cannot pass though losses or credits and that partnerships may retain earnings.

How to qualify as a REIT

To qualify as a REIT, an organization must comply with the following provisions in the Internal Revenue Code:

- Qualify as an entity that is taxable as a domestic corporation
- Be managed by a board of directors or trustees
- Have shares that are fully transferable
- Have a minimum of 100 shareholders
- Have no more than 50 percent of the value of its shares held by five or fewer individuals during the last half of a taxable year
- Invest at least 75 percent of its total assets in real estate assets
- Derive at least 75 percent of its gross income from rents on real property or interest on mortgages financing real property
- Have no more than 25 percent of its assets consist of securities in taxable REIT subsidiaries
- Pay annually at least 90 percent of its ordinary taxable income in the form of shareholder dividends.

Other requirements also apply. For example, compliance includes filing an income tax return on Form 1120-REIT in accordance with IRS filing deadlines. In addition, the REIT annually must mail letters to its shareholders of record, as prescribed by regulations, requesting details of beneficial ownership of shares.

Taxes are paid by shareholders on the dividends received, which may include capital gain dividends. Most states do not require REITs to pay state income tax. Like other businesses, but unlike partnerships or S corporations, a REIT cannot pass any tax losses through to its investors.


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Converting to a REIT

Owners or investors looking to convert to a REIT have three distinct options, all with benefits and challenges influenced by their current structure. Selecting the right option for a given portfolio involves careful consideration of both short-term and long-term implications.

Opco/propco

Real estate assets of a C corporation can be separated from operational activities through a spin-off transaction that creates separate operating and property companies (also known as an "opco/propco structure"). In effect, the corporation is divided into at least two parts: a property company, i.e., a REIT, that owns all the real estate and assets associated with generating real estate rental income, and an operating company that occupies (or uses) those assets. The spin-off transaction can be accomplished in a taxable or tax-free manner, although it is advisable to obtain a private letter ruling from the IRS for any proposed tax-free spin-off. The spin-off can have major repercussions for the opco because it no longer controls the real estate, which the propco can lease to other entities at the end of the initial lease.

Major structuring considerations must be addressed before undertaking an opco/propco structure that utilizes a REIT. For example, under the related-tenant rule, a REIT may not derive qualified rents from a tenant in which it owns, directly or indirectly, 10 percent or more of voting power or value of all classes of stock (or 10 percent or more of assets or net profits). The REIT may require redemptions, or a disproportionate split-up distribution, to avoid the related-tenant restriction. In addition, in connection with electing to become a REIT, the entity will be required to distribute all earnings and profits (E&P), via an E&P purging distribution. Further, the propco will pay corporate level taxes on the inherent "built-in gains" of its assets as of the date of conversion if those assets are sold in a taxable transaction within ten years of the conversion.

Operating partnership structure through an IPO

An alternative to the opco/propco transaction involves the use of an umbrella partnership REIT (UPREIT). In this case, a C corporation contributes real estate assets to an operating partnership. A newly formed REIT issues new stock to shareholders in an IPO, enabling it to contribute cash to the operating partnership. The REIT (through the operating partnership) then leases assets back to the corporation. This alternative will be preferred if a spin-off of the real estate is not viable or if the corporation is unable to handle a large E&P purging distribution. Note that the UPREIT transaction only defers gain and that the C corporation will pay tax when it sells its interest in the operating partnership.

Straight REIT conversion

For a company with an existing revenue stream derived from rents from real property, a straight REIT conversion may be appropriate. In this case, a C corporation elects REIT status and then isolates any nonconforming assets and businesses in a taxable REIT subsidiary.

For a straight REIT conversion, revenue must qualify as rents for use or occupancy of space only, or charges for services customarily furnished in connection with such use or occupancy; the E&P purge must be manageable for the company; the recurring dividend requirement (90 percent) must be acceptable to the company; and the nonqualifying assets or income should be housed in a taxable REIT subsidiary. The REIT must also meet the same organizational, operational, share ownership, asset, and income tests described above.

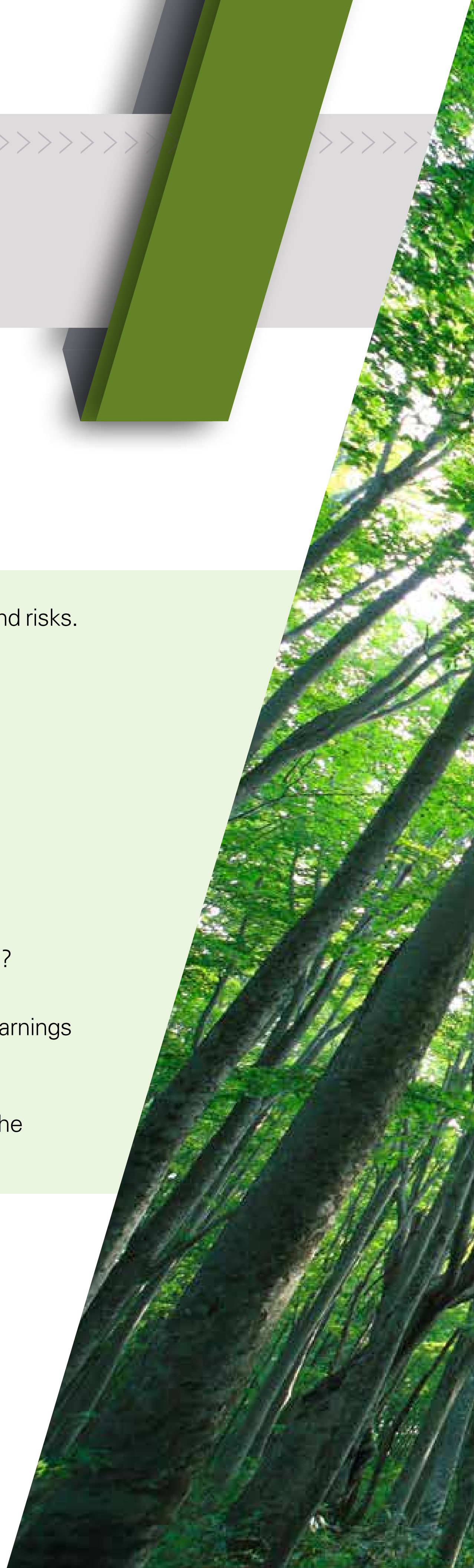
Recent examples of REITs

The majority of U.S. public REITs own and manage traditional real estate sector assets, such as office buildings, shopping centers, lodging facilities, industrial properties and apartment buildings. Since 2008, the healthcare sector has quickly grown to represent a significant component via medical office buildings and other related assets.

However, in recent years, REITs have been formed or proposed with "nontraditional" real estate assets. Recent examples include wireless and broadcast communications sites, a natural gas pipeline system, an electric power transmission system, and terminalling and storage facilities.

Although REITs with nontraditional assets have attracted interest by the media, it is important to note that the IRS has not expanded the definition of real estate for the purpose of creating a REIT. These nontraditional asset categories have been considered real estate for REIT purposes for many years. Due to the increased interest in the use of REITs by entities with nontraditional assets, in June 2013, the IRS formed a working group to review some of these asset classes for REIT applicability.

Thinking about converting to a REIT? Questions you need to ask



As with any major business transaction, REITs offer both rewards and risks. Questions to consider can include the following:

- What is the business purpose for undertaking a REIT initiative?
- Are there substantial qualifying real property assets?
- Are these assets suitable for leasing?
- What structure will be required?
- Will the REIT attract investors with specific investment objectives?
- Can the entity’s business thrive with the burden of not retaining earnings but instead having to repeatedly access the secondary markets?
- Will the business generate dividends consistent with the rest of the listed REIT market so that its cost of capital remains competitive?

Conclusion

REIT conversions require careful analysis, planning and execution. A threshold issue that must be addressed is determining whether the company's physical assets qualify as "real estate assets". In addition, the rent from the assets must qualify as "rents from real property".

Once these thresholds are met, and depending on the overall profile and characteristics of the company, the three alternative restructuring opportunities described above should be considered in securitizing the real estate assets in a REIT. In addition, the tax issues associated with all three alternatives are complex. The potential value associated with unlocking the real estate value must be weighed against the costs and complexity associated with structuring the transaction in a tax compliant manner.

With that in mind, however, the REIT structure can be beneficial to an entity's operations and can provide additional options for stability and growth.

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