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4 Things Real Estate Lawyers Must Know About REIT Deals

By **Andrew McIntyre**

Law360 (May 9, 2018, 4:25 PM EDT) -- The real estate community has been abuzz about a potential wave of real estate investment trust mergers and acquisitions as buyers sit on cash and share prices lag.

The Blackstone Group LP is the latest buyer to enter the REIT M&A ring, with its whopping $7.6 billion purchase earlier this month of Gramercy Property Trust, and lawyers say such deals require a skill set outside the typical realm of real estate law.

Attorneys have to have a deep understanding of how tax drives REITs, but also need to understand rules and regulations when it comes to qualifying assets and income.

"REITs are really a creation of the tax code, with a corporate securities overlay, so I'd say deep knowledge of tax, with some corporate securities knowledge as well, would be important," said Jesse Sharf of Gibson Dunn & Crutcher LLP.

Here, Law360 looks at four things real estate lawyers need to know as they help their clients navigate successful REIT deals.

Have a Deep Knowledge of Tax

Despite by definition being companies that own real estate, tax is really at the root of all REITs, and any deal involving REITs requires knowing the tax laws inside and out, lawyers say.

"From a corporate perspective, it is important to recognize that other areas of the law have a significant impact on the client or potential client ... [since] REITs are creatures of the federal tax code," said Michael Hermsen of Mayer Brown LLP.

"It is really important to understand how advice you might be giving fits within the dictates of the tax code. You can't assume that advice you might give to any client automatically will be the best advice for a REIT," Hermsen added.

REITs by definition have to distribute at least 90 percent of their earnings as dividends and are taxed differently than traditional corporations.

And they also need to carefully track their income source, a topic that will be visited in a later section of this article. In short, REITs are constantly subject to scrutiny under the U.S. tax code, particularly when a deal is in the works.

"REIT tax law is a highly technical area, and relying on a transactional tax attorney who doesn't know REITs in depth will routinely lead to late restructuring to fix defects that could have been identified upfront, and often [to] a lot of avoidable drama," said William Cernius of Latham & Watkins LLP.

Understand Income and Asset Requirements

While real estate lawyers need to understand the tax framework of REITs, they also need to have a deep knowledge of asset requirements and income requirements, two key pillars of the REIT framework as defined by Congress when it created REITs in 1960.

"Familiarity with what is considered good REIT income and what's considered bad income" is paramount, according to Michael Haas of Latham & Watkins.

And that's particularly key when one or two REITs are involved in a potential deal, since the income test will be applied to the new entity. At least 75 percent of REIT income has to by law come as income from real estate assets.

The definition of what qualifies as real property for REIT purposes, though, **has broadened** over the past several years to include billboards and even copper wiring. Qualifying assets need to produce income, which is a staple of the REIT model: investing in income-producing "assets."

In the case of hotels, for example, many REITs own them but are required to then lease the properties to an operator to meet that income requirement.

"Income from operating the hotel is bad REIT income but an operator paying rent is good income," Haas said. "REITs are very different animals. Anyone representing a REIT must have a minimum understanding of those requirements."

And the requirements for income and assets ultimately point back to the tax laws and offer a roadmap for what REITs must do to comply.

"REITs must satisfy a variety of complex rules, including as to their organization and operations, as to which types of assets they can hold and as to which types of income they can earn," said Richard Nugent of Jones Day.

Know How to Deal With Non-REIT Assets

While it's one thing to understand how to treat assets that qualify as real property for REIT purposes, it's also important to understand rules for non-qualifying assets.

REITs may own certain assets that fall outside the realm of qualifying assets, such as a non-income producing tract of land, and those assets need to be treated with care and properly accounted for, so as to not lose the company's REIT status, experts say.

Larry Crouch of Shearman & Sterling LLP said REITs generally have to set up corporate subsidiaries to hold non-qualifying assets.

Firms, for example, may need to spin off certain non-qualifying assets in order to get them off their books, either to maintain REIT status or to satisfy requirements for what a new entity would look like if a REIT is seeking to do a deal.

There, again, the question typically makes its way back to a question of complying with tax laws — in this case, tax laws governing assets, lawyers say.

"While real estate and corporate lawyers may have a general familiarity with some of these rules, it's really vital to complement their general understanding with tax expertise," Nugent said.

Understand M&A Issues

While it's one thing to advise a REIT on its day-to-day dealings, it's another to work on an M&A deal in which one or both parties is a REIT, and lawyers say various issues can crop up.

While a REIT's structure may be well and good on its own, another set of calculations must be made to ensure the combined company also ticks all the required boxes as far as federal REIT rules are concerned.

One major issue is doing an analysis of leases, which are under heightened scrutiny when REITs are involved.

"You need to consider how the transaction or arrangement will impact the company's REIT status," Nugent said. "For example, leases must be scrutinized to ensure that amounts paid by the lessee will qualify as valid rents from real property under the REIT rules."

And, as it often does, the question of tax comes into play, and lawyers need to understand options for structuring the deal itself.

Companies buying a REIT may be able to pay little or no material corporate tax on the transaction depending on how it's structured, Crouch said.

And lawyers say seasoned tax attorneys need to be brought on board to help structure the deal.

"Beyond the formation stage, the REIT rules need to be in the back of practitioners' minds whenever a REIT considers entering into a transaction or other commercial arrangement," Nugent said.

--Additional reporting by Jimmy Hoover. Editing by Kelly Duncan and Rebecca Flanagan.