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Unique Risks Posed By REIT Acquisition

By **Jade Newburn, Heather Adkerson, Jeffrey Bruns, David Malinger and Matthew McDonald**
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Jade Newburn

Private equity real estate funds and other sophisticated investors in U.S. real estate assets may raise capital from foreign investors. To achieve tax structuring objectives for these investors, these investment vehicles are often structured to hold one or more real estate assets in a private real estate investment trust. In many cases, the exit strategy for these investments consists of selling the common shares of the REIT itself, rather than the underlying asset(s), to reduce tax liability for non-U.S. investors upon the sale. A prudent buyer should understand and seek to mitigate the unique risks posed by a REIT share acquisition.

Brief Background of Private REITs

Heather Adkerson

A private REIT is an entity whose assets are substantially comprised of real estate assets (debt or equity or both) and whose ownership interests are not publicly traded. From a tax perspective, a REIT is treated as a corporation. As long as the REIT complies with a complex set of tax rules and regulations in accordance with the Internal Revenue Code and U.S. Treasury Department regulations, including satisfying minimum distribution requirements and a multitude of tests regarding ownership, income, assets and corporate governance, the REIT is allowed a deduction for dividends paid to its owners. Assuming the REIT distributes all or substantially all of its taxable income as dividends annually, this treatment substantially eliminates the “double taxation” at both the corporate and owner levels that generally results from the use of corporations.

Jeffrey Bruns

REITs are appealing to non-U.S. investors for various reasons. First, REITs generally “convert” operating income from real estate assets into dividend income, potentially reducing an investor’s U.S. tax liability and/or U.S tax return filing obligations during the ownership phase of an investment.

Second, a non-U.S. investor's gain from the sale of shares of a "domestically-controlled REIT" (i.e., 50 percent or more of the REIT is owned by U.S. shareholders), as opposed to a sale of the underlying asset(s), generally is not subject to taxes and withholding that may otherwise be imposed under the Foreign Investment in Real Property Tax Act. Special rules applicable to sovereign wealth funds may allow them to similarly benefit from selling REIT shares even if the REIT is not domestically controlled. Although recent changes to FIRPTA created an exemption for qualified foreign pension funds (QFPFs) from the FIRPTA requirements, the frequency of REIT share sales in the market has not appeared to diminish - likely because QFPFs tend to make up only a portion of the non-U.S. investor base in these investment vehicles.

David Malinger

Transaction Structuring

Consistent with any purchase of equity interests, the buyer's equity interest in the REIT will be structurally subordinate to that of the creditors of the REIT. However, from an economic perspective, the buyer's initial determination of the purchase price typically does not include a reserve or discount for potential liability for any preclosing tax, compliance and other potential liabilities of the REIT. Buyers typically mitigate these risks through due diligence, appropriate representations and warranties, third party insurance and other credit support, and other factual considerations.

Matthew McDonald

Due Diligence

As with all entity purchase transactions, a careful REIT share buyer should investigate potential entity-level risk — including reviewing insurance loss histories; performing judgment, lien, UCC, bankruptcy and similar court searches; and reviewing the organizational documents and public filings of the to-be-acquired REIT — as well as perform customary property-level due diligence such as lease audits and operating statement reviews, physical condition assessments, environmental studies, tenant interviews and estoppels, zoning diligence and title and survey review.

Because the buyer will be acquiring any prior tax liabilities of the REIT, the buyer and its tax advisors should also comprehensively review the REIT's tax returns and operations to evaluate the risk that the seller violated REIT rules or otherwise incurred unpaid REIT-level taxes during its period of ownership, including:

- Conducting interviews and other diligence to determine whether the REIT satisfied applicable income, asset and distribution tests, and attempting to quantify risks relating to past income tax filings;

- Reviewing any prior sales history of the REIT to determine whether the REIT engaged in prohibited transactions, such as selling property as a dealer rather than investing as a long-term owner of real estate;

- Reviewing the organizational and corporate documents of the REIT, including confirming that no five or fewer individuals directly or indirectly own more than 50% of the REIT and that the ownership interests in the REIT are transferable;

- Confirming that there are at least 100 shareholders of the REIT (generally comprised of individual preferred shareholders) and adjusting the purchase price to take into account the redemption payments that would be due to those preferred shareholders as of the closing; and

- Evaluating the relative advantages, disadvantages and tax consequences of maintaining the REIT after acquisition as opposed to liquidating the REIT as soon as possible after the transaction.

The buyer will also need to confirm that its ownership of the REIT will not cause the REIT to lose its REIT status, for example if the buyer's ownership would cause five or fewer individuals to directly or indirectly own more than 50 percent of the REIT or would cause the REIT to be deemed to be "related" to a significant tenant of the REIT.

Whether and how long the buyer will be required to maintain a purchased REIT is sometimes negotiated between the parties. For example, a seller of a recently formed REIT may try to require a REIT to be maintained by the buyer for a certain period of time after closing either to mitigate the risk that the sale and liquidation of the REIT might be viewed as a prohibited transaction or to support a position that the REIT was not transitory. Foreign buyers may want to continue the REIT after closing to maintain the income conversion advantages noted previously; however, buyers that do not derive any tax advantages from owning property through a REIT may want to dissolve the REIT to obtain a step-up in the tax basis of the underlying asset(s) or to eliminate the compliance and oversight costs and requirements of maintaining a REIT.

Representations, Warranties and Credit-Support

At closing, the buyer must obtain clean title to the REIT. Unlike a deed transfer, the buyer cannot independently confirm the ownership of the REIT because the ownership is not publicly recorded. Accordingly, a careful buyer will require the seller to make certain "fundamental representations" — which include that the seller is the sole owner of the common REIT shares and that no encumbrances, liens, rights or options of purchase or contingent liabilities exist. Because the seller is typically an entity that only owns the REIT shares and typically distributes most or all of the proceeds of sale to its owners at closing, the buyer will typically demand lengthy survival periods for these representations, full recovery for any inaccuracy, and a back-stop — whether in the form of a guaranty or a holdback, or potentially, through the purchase of representation and warranty insurance and/or UCC insurance from a third-party insurer. Although the seller and its affiliates should, in theory, be willing to provide such assurances indefinitely and without a cap on liability, the seller may wish to limit its potential liability — including, for example, if the sale is made in connection with the liquidation of the investment fund.

The purchase agreement should also include a variety of representations and warranties from the seller regarding the REIT's compliance with applicable law and the tax status and filing characteristics of the REIT, with appropriate survival periods, liability caps and credit support. To gain additional comfort, a buyer usually requires a legal opinion from the seller's tax counsel that supports the tax qualification of the REIT. These representations, warranties, credit-support and opinions are often heavily negotiated in the purchase agreement. In practice, buying REIT shares from a large institutional investor is often an additional risk mitigant, as such an owner often has a longer track record and better institutional controls, experience and records. Despite these contractual and other protections, the buyer is in a somewhat more risky position than if it had simply purchased the underlying asset.

Conclusion

Buying REIT shares comes with a variety of risks, including, but not limited to, those identified in this brief summary. A potential buyer should consult with its tax and legal advisers before doing so.

Jade E. Newburn, Heather W. Adkerson, Jeffrey M. Bruns, David Malinger and Matthew A. McDonald are partners at Mayer Brown LLP.

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