THE USE OF MASTER LEASES IN COMMERCIAL REAL ESTATE TRANSACTIONS

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There is no single legal definition of a "master lease." Such an arrangement may be used in equipment leasing as well as in the real estate space. A master lease may be an alternative to traditional bank financing or a means of credit support. It also may figure prominently in the context of tax planning, most notably for entities taxed as "real estate investment trusts" ("REITs") under the U.S. Internal Revenue Code of 1986, as amended (the "Code").[1] This article will describe some of the uses of master lease structures for these purposes.[2]

MASTER LEASES AND TAX PLANNING

Tenancy in Common / Section 1031 Structures

Master leases may arise in Section 1031 like-kind exchanges. Section 1031 provides for the deferral of gain or loss on the exchange of business or investment property solely for property of "like kind."[3] The rationale behind the provision is that when an investor exchanges a piece of property for like-kind property, the investor is merely continuing an ongoing investment, rather than liquidating one to obtain another.[4] Thus, gain or loss is deferred until the investor's funds are no longer tied up in the same kind of property. In order to obtain such deferral, certain requirements must be met. The replacement property must be of like-kind with respect to the relinquished property.[5] It must be identified within 45 days of the transfer of the relinquished property, and generally must be received by the transferor within 180 days of the transfer of the relinquished property.[6] In addition, both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment and must not be stock in trade, other property held primarily for sale, stocks, securities, partnership interests, and similar intangibles.[7] A "partnership" for such purposes includes any unincorporated organization through or by means of which any business, financial operation or venture is carried on.[8] Generally, and in light of the policy rationale behind Section 1031, the courts have interpreted its provisions liberally in order to allow taxpayers to come within its terms.[9]

Real estate syndicators have created an industry offering tenancy in common (TIC) interests in professionally managed rental real estate as the like-kind replacement property required to complete a Section 1031 exchange. A TIC is an undivided fractional interest in real property that is generally considered to be of like-kind with property that is wholly-owned. Syndicated TIC interests are easy to identify within the 45-day identification period and close on within the 180-day exchange period. In addition, TIC interests provide taxpayers with the opportunity to invest in rental real estate and achieve tax deferral, all without the burdens of managing the real estate. As attractive as TIC interests are, they do come with some risk. The common ownership of property has under certain circumstances been treated by the IRS and courts as a deemed partnership for tax purposes.[10] Thus, TIC arrangements intended to qualify for Section 1031 treatment must be structured carefully to prevent the interests from being treated as disqualifying interests in a partnership or other entity.

In 2002, the IRS issued a Revenue Procedure stating that the IRS "will consider a request for a ruling that an undivided fractional interest in rental real property… is not an interest in a business entity" if the arrangement meets the 15 conditions specified therein.[11] Those conditions, while not technically a safe harbor, are sometimes treated as such for planning purposes. The conditions include that all the tenants must hold their interests as a tenant in common under local law, there are no more than 35 TIC owners, the TIC owners must not hold themselves out as members of an entity or file any type of entity tax return, unanimous vote is required for the hiring of management and the sale, leases, or re-leases of the property or any portion of the property, and the TIC owners must not engage in business activities with respect to the property other than those that are "customary activities" related to maintenance and repair.[12] As a practical matter, when TIC interests are held by more than a few owners, satisfying the unanimous vote concept can become extremely onerous.

Enter the master lease. Master leases provide a solution to such restrictive conditions, and they are often used in TIC arrangements as a way to achieve compliance with the Revenue Procedure. For example, TIC owners can lease the rental real estate to a master tenant under a long-term lease, and the master tenant then subleases the property to multiple tenants. Under such a scenario, the TIC owners need only make a single unanimous decision in selecting a master tenant. The master tenant will then manage the project and make leasing decisions, relieving the TIC owners from having to reach unanimous decisions with respect to daily operations. Relegating the management of the project to the master tenant also insulates the TIC owners from being characterized as conducting business activities beyond those that are customary and thus the arrangement from being considered a disqualifying interest in a partnership or other entity.

MASTER LEASES AND REITS

Background on REITs

REITs provide investors with an opportunity to invest in a professionally managed pool of real estate in a tax efficient manner. In general, REITs are organizations that are treated as corporations for U.S. federal tax purposes but receive special tax treatment under the Code that makes these vehicles more tax efficient than traditional subchapter C corporations. They also can be an extremely efficient vehicle for foreign persons to invest in U.S. real estate while mitigating the impact of Sections 897 and 1445 (FIRPTA). The special tax treatment is only available to the extent that a REIT's income is from passive sources and the REIT does not engage in any active trade or business.[13] The tax efficiency is achieved through a REIT's ability to deduct the income distributed out to shareholders, thus eliminating the double taxation typical of corporate income and instead delivering pass-through or conduit treatment to its shareholders. The benefits of the REIT structure, however, come with the added burdens of establishing and maintaining qualification under the REIT rules for U.S. federal income tax purposes. The REIT rules impose complex organizational and structural requirements, income and asset tests, and distribution and record keeping requirements.

In particular, each year, a REIT must satisfy two different income tests, which are designed to ensure that the income derived from the REIT is in fact passive in nature. The first test requires that for each taxable year, at least 95 percent of a REIT's gross income must be derived from dividends, interest, rents from real property, gains on dispositions of stock, securities, and real property not held for sale to customers in the ordinary course of business, income and gain from foreclosure property, fees received for making mortgage loans and entering into purchase contracts and leases, and certain related items.[14]

The second test requires that in addition to the 95 percent income test, at least 75 percent of the REIT's income for a taxable year must be derived from real property investments including rents from real property, interest on real property mortgages, gains on dispositions of real property not held for sale to customers in the ordinary course of business, dividends from other REITs, gains on dispositions of shares of other REITs, income and gain from foreclosure property, refunds of real property taxes, and "qualified temporary investment income."[15]

Rents from Real Property

Both REIT income tests provide that "rents from real property" qualify as "good income" (i.e., income that is included in determining whether the 95 percent or 75 percent threshold is met). As discussed below, the Code defines "rents from real property" by describing examples of what is included in the phrase and what is excluded from it. The Treasury Regulations add that "rents from real property" means amounts received "for the use of, or the right to use, real property."[16]

The phrase "rents from real property" is defined to explicitly include "rents from interests in real property" as well as rent attributable to personal property leased with the real property, provided that, the rent attributable to such personal property is 15 percent or less of the total rent for the year.[17] Charges for customary services rendered in connection with the rental of real property are also included as qualifying "rents from real property," and are thus good income.[18] For example, the provision of utilities would be a customary service that would not disqualify the rent attributable to the leased property from satisfying the annual income tests.[19] Window cleaning, cleaning of common spaces, general maintenance and janitorial services, collection of trash, elevator services, telephone and answering services, incidental storage space, provision of laundry equipment, guard services, parking facilities and swimming pool facilities are all examples of services that are typically viewed as customary.[20] In each case, however, the services must be rendered to the tenants (or for the benefit of the tenants) and must be furnished through an independent contractor (IK) from whom the REIT does not derive any income.[21] The evolution of the REIT rules governing tenant services is beyond the scope of this article, and is nuanced in many ways as a result of various amendments to the Code and IRS interpretation over the years.

Various categories of gross income are explicitly excluded from the definition of "rents from real property" and give rise to "bad income." Amounts that are contingent on the income or profits derived by any person from the use of the property are excluded unless the amounts are based on a fixed percentage of sales or receipts.[22] Rents are also excluded if they are received from a person in which the REIT owns a 10 percent or greater equity interest.[23] This "related party rent" prohibition looms large in the context of master leases and will be described further below. Finally, rents attributable to impermissible services provided by a REIT to a tenant are also excluded from qualifying "rents from real property."[24] Impermissible services are more than de-minimis services that are furnished or rendered by the REIT to the tenant or the managing or operating of the property by the REIT.[25] Generally, services rendered through an IK or a "taxable REIT subsidiary" ("TRS") do not give rise to impermissible service income. Special rules exist in the context of hotels and healthcare facilities, where significant, non-customary services are routinely provided on the premises. The REIT rules clarify under what circumstances rent from such facilities will be considered "rents from real property" and are important to consider when structuring such arrangements.

REIT MASTER LEASE STRUCTURES

Qualifying Hotels and Healthcare Facilities

In an effort to navigate the rules described above relating to impermissible tenant services and related party rent restrictions, many REITs have implemented master lease structures of various types. These arrangements share a common thread — namely, they convert what otherwise would be prohibited REIT income into more traditional income that meets the definition of "rents from real property" under Section 856(d). For REITs, the objective is to do so in a manner that allows the REIT and its shareholders to enjoy the underlying economics of the property (and its operations) to the greatest extent possible. To the extent this can be achieved, the tax-advantaged REIT structure can be used to hold a wide range of assets. It also allows foreign investors to invest in these properties while minimizing U.S. tax inefficiency and avoiding some of the adverse tax consequences arising under FIRPTA. In this section we will explore a few of the ways in which REITs use master leases.

Many REITs hold hotel properties, as well as nursing and assisted living facilities.[26] The very ability to hold these asset classes within a REIT structure is somewhat novel, since hotels and nursing homes entail a level of services that predominate as compared to the occupancy value provided to "tenants." Simply put, hotel guests are not paying "rents" as such term is defined under the REIT rules. Instead, they are paying for a suite of services that includes a temporary occupancy right.[27]

Prior to 2001, REITs were required to master lease the hotel or assisted living facility to an unrelated tenant. In doing so, the REIT would give up both control of the property as well as some of the key economics. In 2001,[28] Congress enacted an intricate set of provisions making it easier for REITs to keep the business "in house" and retain more direct privity with the party actually operating the asset. Specifically, for assets that meet the definition of "qualified lodging facility" or "qualified health care property,"[29] the Code contains an exception to the related party rent rule for leases of such properties to a TRS so long as they are operated by an "eligible independent contractor" ("EIK") as defined in Section 856(d)(9).[30] A contractor is *independent* as long as it neither owns more than 35 percent of the REIT nor is 35 percent of its equity owned by a person who is related directly or indirectly to the REIT. In order to be considered an *eligible* independent contractor, the independent contractor must have been actively engaged in the trade or business of operating or managing either qualified lodging facilities or qualified healthcare facilities for any person unrelated to the TRS at the time it enters into a management contract with the TRS.[31] If the requirements of this exception are met, the rent paid by the TRS to the REIT with respect to a qualified hotel facility or a qualified hospital facility generally will be treated as qualifying "rents from real property" for purposes of both the 95 percent and 75 percent annual income tests.

In many modern-day real estate private equity fund structures, the hotel manager is an affiliate of the fund's sponsor. The EIK analysis may become extremely involved and may necessitate substantial restructuring due to the operation of the intricate attribution rules. For example, if a fund or other entity is owned by persons who also own the REIT and the manager, the latter may be disqualified as an EIK.

A typical hotel REIT structure involves a master lease between the REIT (or an operating partnership owned by the REIT) and its TRS. The master lease usually calls for fixed rent plus additional rent based on a percentage of gross revenues.[32] The terms of these leases are usually between two and five years. The TRS enters into a management agreement with an operator to manage the hotel or healthcare facility. The TRS will typically earn a spread, comprised of the difference between its revenue from operations and its management fee expense. Because of limitations on the amount of REIT rents that can be attributable to personal property, it may be necessary in hotel REIT structures for the TRS to take ownership of some of the furniture and other fixtures that constitute personal property.

Negotiating the financing of a hotel REIT can be complex. The primary mortgagor will be the REIT itself, as the owner of the property. However, lenders may seek more direct access to the TRS/lessee as well. There are a number of ways to accomplish this. For example, the TRS may provide a pledge of assets under its master lease with the REIT, which can then "on-pledge" the assets to the lender pursuant to the first mortgage. Some lenders will require the TRS to be a borrower, in addition to the REIT property owner. Others may only require a pledge of the master lease itself. Additionally, when a mezzanine financing is in place, it is not uncommon for lenders to insist on a pledge of the membership interests in a parent entity to the TRS.

It should be noted that the hotel and healthcare facility structure is one of two primary exceptions to the related party rent restrictions applicable to TRSs. Under the "limited rental exception" of Section 856(d)(8)(A), a REIT may receive rent from a TRS if at least 90 percent of the leased space of the property is leased to persons unrelated to the TRS and the REIT, and the rents paid by the TRS are "substantially comparable" to those paid by such unrelated persons.[33] This exception will be very useful to a REIT that owns real estate that a TRS must access in order to perform tenant services.[34]

Non-qualifying Hotels and Healthcare Facilities & Other "Non-traditional REITs

Master lease structures are also likely to arise in the context of senior living facilities or hotels that do not meet the definition of "qualified lodging facilities" or "qualified health care properties." Section 856(d)(9)(D) provides that a lodging facility includes hotels, motels and any other establishment "more than one-half of the dwelling units in which are used on a transient basis." Under this rule, it is not clear that extended stay suites would qualify.[35] Without the protection of the special exception, REITs that own these assets are unlikely to be able to avoid impermissible services, and may even have trouble concluding that the income they earn is "rent" for tax purposes. In these cases, the REIT may be able to hire an independent third party (or a TRS) to provide all services and have the tenants pay the REIT solely for the occupancy of space.[36] An arguably "cleaner" alternative is to enter into a master lease of the property with an unrelated party that will operate the asset.

Master lease structures for REITs are by no means limited to hotels and nursing facilities. In fact, master leases may be featured in connection with ownership of numerous categories of "nontraditional" REIT assets, or those that would not typically earn quintessentially "rental" income due to significant tenant services or other factors. With respect to parking facilities, for example, a REIT generally cannot derive income from making parking spaces available to third parties unless the REIT master leases the parking garage to an operator pursuant to an arrangement that is respected as a true lease for tax purposes.[37] Master leases to operators can take many forms, but they will usually include percentage rent based on the gross revenue. Energy or infrastructure assets (such as power plants) may be held in a REIT that owns the associated fixed assets, with the lessee/operator earning income from generating the power and selling it off to the grid. Master leases are also found in farmland REITs, where farmers lease crop farmland under triple net leases.[38]

REITs that structure their assets under master leases are clearly giving up some of the operational upside of the business, when compared to a structure in which the tenant services are kept "in house" either through an independent contractor arrangement or a TRS. A 2004 IRS ruling describes a cold storage company that had in place a master lease structure where all properties were leased to an independent lessee/operator under certain long-term master leases. The operator provided food manufacturers, distributors, and retailers with temperature-controlled storage space as well as handling, transportation, and other supply chain services. The company proposed to terminate the master leases and cause its newly formed, wholly-owned TRS to acquire the operator. Thereafter, the logistics services were provided to cold storage customers through one or more TRSs of the company. The IRS approved of the proposed arrangement, finding that the rent the company would receive from leasing the storage space directly to customers would qualify as rent from real property and the fees attributable to services to be performed by the TRS would not be attributed to the company.[39]

For REITs, the most important features of these master leases (aside from their being respected as true leases for tax purposes) is that (1) the rent is good rent for REIT purposes, and (2) the operator is not disqualified as a related party tenant. In many master lease transactions, the property owner/lessor is trying to approximate a joint venture arrangement with the operator whereby the parties share the profits from the operation of the property. This requires carefully structuring the rent terms in a way that meets the "rents from real property" definition. It is commonplace, particularly in retail REITs, for a master lease to provide for fixed rents and percentage rents. While percentage rents based on a tenant's net income or profits is impermissible, rents based on a fixed percentage of gross receipts or sales qualify for REIT purposes.[40] Furthermore, rent can be computed as a percentage of gross sums over a fixed dollar amount, so long as the fixed amount does not change over the term of the lease and is not itself based on net income or profits.[41] While this allows parties to replicate a profit sharing arrangement to some degree, care must be taken not to create what is functionally a net profit-based rent. In particular, building too many reductions into the gross receipts computation increases the risk that the formula will be viewed as a net income-based rent. Customary business practices relating to the computations of gross receipts are taken into account for these purposes.[42]

As a result of these restrictions, an investment in a REIT owning these types of assets will not be economically identical to owning these assets directly and being subject to the business risks of the underlying operations. Instead, the business essentially will be divided into a real estate component and an operating component. To be sure, a percentage rent formula based on gross revenue will cause these two components to be generally aligned. Nonetheless, dislocations could occur if, for example, the expenses of operating the business increase unexpectedly.

Propco/Opco Structures and REIT Spinoffs

In September 2013 the IRS issued the first private letter ruling approving the tax-free spinoff of a stand-alone REIT by a C corporation.[43] This ruling, issued to Penn National Gaming, Inc., ("PNG") was groundbreaking for a number of reasons, primarily relating to various requirements under Section 355, such as the "business purpose," "device" and "active trade or business" requirements. The property company ("Propco"), a REIT spun off from PNG ("GLPI"), held the casino and gaming real estate and triple net leased the properties under a 35-year master lease agreement (including extensions) to an operating company ("Opco") affiliate. An interesting element of the PNG transaction was that a couple of significant shareholders that owned in excess of 10 percent of the company were required to sell or restructure their interests in the companies in order to avoid a related party rent problem under Section 856.[44]

After Penn National's REIT spinoff, other companies in varying industries consummated similar transactions. For example, the Ensign Group Inc. in June 2014 spun off CareTrust REIT Inc., which holds Ensign's skilled nursing, assisted living, and independent living properties. CareTrust entered into an Propco/Opco lease with Ensign and elected to be a REIT.[45] Also in 2014, CBS Corp. split off its outdoor ad business, CBS Outdoor Americas Inc., which later changed its name to Outfront Media Inc.[46] Other companies such as Windstream Holdings Inc., Caesar's Entertainment Corporation and Hilton Worldwide Inc. soon followed suit.[47] While recent legislation has shut down the tax-free REIT spinoff,[48] variations of this "Propco/Opco" structure remain viable, and, like PNG, utilize master leases. For instance, Sears Holding Corp. completed a *taxable* spinoff of Seritage Growth Properties in July of 2015.[49]

One taxpayer deployed a "captive REIT" variation of the REIT spin-off in order to monetize its real estate portfolio. In particular, in 2016, publicly traded hospitality company MGM Resorts International (MGM) contributed seven large Las Vegas resort properties and three gambling casinos to a newly formed REIT, which then leased the property back to a subsidiary of MGM pursuant to a master triple-net lease.[50] The master lease provides for an initial lease term of 10 years with the potential to extend for four additional five-year terms. It also requires the tenant, the MGM subsidiary, to pay substantially all costs associated with each property (including real estate taxes, insurance, utilities and routine maintenance) and rent. The rent is comprised 90 percent of base rent, which is subject to an annual fixed rent escalator of two percent until 2022, and 10 percent of percentage rent, which will be fixed for the first six years, and will then be adjusted every five years based on the average annual net revenues of the MGM subsidiary and any subtenants. It also provides the REIT with a right of first offer with respect to a few of MGM's other key development properties.[51]

All these PropCo/OpCo transactions share a basic feature in that they rely on large master lease arrangements and do so in a way that navigates the REIT rules governing rents from real property. The master lease structure allows for the lessees to make tax-deductible rent payments in exchange for the right to use the PropCo's facilities. The rental income is not subject to corporate tax as long as PropCo qualifies as a REIT and distributes the income to its shareholders. In this way, these taxpayers have been able to creatively make use of the REIT regime and the master lease structure to deliver value to shareholders in a tax-efficient manner.

True Lease Analysis

As the above discussion makes clear, the lynchpin of the master lease structure for REITs is the qualification of the master lease itself as a "true lease" for U.S. federal income tax purposes. Since the stakes for REITs are so significant (namely, the very qualification of the property owner as a REIT), public disclosure will typically describe the risk that the leases will not be respected.[52] Furthermore, REITs will typically seek opinions of counsel that specifically address the treatment of the lease, even when the REIT otherwise receives a qualifying REIT opinion.[53]

Historically, much of the caselaw and guidance in the lease area has emerged from sale-leaseback transactions, when the relevant question is whether the nominal buyer/lessor is respected as the tax owner of the property or alternatively whether the transaction is simply a disguised financing.[54] In master lease structures, the analysis is somewhat more nuanced, since the REIT is likely to be respected as the owner of the property. Instead, the relevant question is whether the relationship with the operator is respected as a lease or instead recast as a service or management contract, or joint venture.

According to the U.S. Tax Court, the two primary factors that indicate the existence of a management contract (as opposed to a lease) are (1) control of the venture by the property owner, and (2) risk of loss on the property owner.[55] Section 7701(e) provides, somewhat tautologically, that "a contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors." The provision then enumerates various factors that are relevant in the determination, including whether or not (a) the service recipient is in physical possession of the property, (b) the service recipient controls the property,(c) the service recipient has a significant economic or possessory interest in the property, (d) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (e) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (f) the total contract price does not substantially exceed the rental value of the property for the contract period.

Legislative history and caselaw suggests that the "control" and "risk of loss" factors are the most important.[56] Specifically, the "true lease" inquiry hones in on the degree of control exercised by the nominal lessor in order to determine whether the relationship between the parties is disguised as a lease but is really one of principal and agent. Certain economic terms should be avoided. For example, if the tenant is only required to pay rent if its use of the property results in true profit, that would be indicative of a management arrangement and not a genuine lease.

In a true lease, the lessee has no recourse in the event operating expenses exceed the amounts that it is entitled to retain. The landlord's absolute ability to terminate the tenant's right to possess the property, or the ability to sell interests in the property without tenant's consent, is also indicative of a management arrangement and not a lease.[57]

A complete discussion of the true lease analysis is beyond the scope of this article, but it is important to note that subtle economic features of these transactions can greatly impact the analysis.[58] Tax advisors must focus on contractual terms such as insurance requirements, record-keeping obligations, tenant financing rights, and casualty losses. Therefore, great care is needed in drafting master leases to ensure that the intended tax treatment is achieved, especially in the high-stakes world of REITs.

MASTER LEASES AS CREDIT SUPPORT

In addition to their use in TIC and REIT-structuring transactions, master leases may be used as a credit-support tool in commercial real estate transactions. Although a master lease structure allows significant creativity to the parties in deal-making and overcoming transactional obstacles, a master lease structure is just one of a number of credit-support tools and should be analyzed in light of all available options.

For purposes of this discussion, a master lease is a lease of rentable space in a commercial real estate asset that is structured to provide a predictable stream of rental payments over a defined term to support the economic performance of the asset but the master tenant usually does not have the right to occupy the premises. Generally, the tenant will master lease the entire premises; however, in certain cases, the tenant may master lease a portion of the total space.[59] Most frequently, master leases are used to provide assurances to the owner of a real estate asset or its lender or both that the asset has "sufficient" rents (or projected rents) to enable the counterparty to move forward with a transaction—whether it be increasing the net operating income of an existing asset or mitigating risk in a development transaction.

EXAMPLE USES OF MASTER LEASES

As a creature of contract, master leases may afford significant transactional flexibility. Examples of master lease structures as credit support include:

Bridging a Gap in Net Operating Income in a Financing Transaction

A buyer desires to acquire a vacant office building. The sponsor may possess expertise in owning and managing office buildings, but the ownership group may contain investors that are not willing to invest in a speculative asset. In such a circumstance, the sponsor or one of its affiliates would master lease the building. The master lease would permit subleases and even direct leases with the owner to sub-tenants that would occupy the premises. The sponsor/master tenant subleases space to office tenants, providing the owner with a predictable income stream and reduced operating risk and permitting the sponsor/master tenant to maximize sublease value and retain profits in excess of rent and other payments.[60],[61]

Bridging a Gap in Net Operating Income in a Sale Transaction

A seller desires to sell a retail shopping center but the center has insufficient net operating income (as analyzed by the buyer and/or its lender) to support the seller's required price or the required amount of debt proceeds or both. In such a circumstance, the seller or one of its credit-worthy affiliates might enter into a master lease on a vacant space for a defined period of time, perhaps placing the rent in escrow or providing a letter of credit, thus increasing the net operating income until the vacant space is let to an acceptable tenant (as discussed below).[62]

Bridging a Revenue Gap in a Development Transaction

A hospital desires to increase the amount of medical office building space on its hospital campus. The developer and lender require the hospital or one of its credit-worthy affiliates to master lease the entire premises for a minimum cash flow to underpin the financial capacity of the project and reduce the speculative nature of the development. When the hospital finds an acceptable medical practice or related provider, the master lease would provide that such tenant may enter into a new lease with the landlord (with the result that the hospital's obligations under the master lease would burn off in part). In such a lease, the burn-down provision and the conditions to its burn-off should be carefully negotiated — especially relating to the lease term, any required economic terms of a sublease (such as minimum rent, minimum term, tenant concessions and build-out costs), any required characteristics of the sub-tenant (including credit-worthiness) and any use or tenant mix restrictions.

Structuring Considerations

Similar to any lease, the landlord's (and its lender's) underwriting of a master lease would be expected to include the identity and credit of the tenant, the tenant's permitted use of the space and the tenant's source of funds for rental payments; however, a master lease may be riskier than a typical third party space lease because the master tenant does not rely on the premises for its business operations and therefore is not compelled to pay rent.

From a landlord's perspective, master leases carry at least two additional risks — the bankruptcy of the master tenant and a potential re-characterization of the master lease as a guaranty.

Tenant Bankruptcy

Generally, the U.S. Bankruptcy Code enables insolvent debtors to reorganize in a manner that enables them to continue as ongoing enterprises. During the pendency of the bankruptcy case, a tenant has a number of significant rights that could affect the landlord's rights under the master lease, including the imposition of the automatic stay after a bankruptcy filing (which prevents a creditor such as a landlord from attempting to collect its outstanding debts against the tenant during the bankruptcy (including the right to receive rents)) and the right to assume or reject real property leases.[63]

In a bankruptcy proceeding, rent that accrues but is not paid prior to the bankruptcy filing is a general claim against the bankruptcy estate. After the bankruptcy filing, a landlord has an administrative claim for the period the tenant occupies the premises from the date of bankruptcy through the date on which the lease is rejected and a general unsecured claim limited to the greater of one year's rent reserved under the lease or 15 percent of the rent reserved for the remaining term of the lease (not to exceed three years of rent).[64] The time delay associated with a potential bankruptcy filing as well as the potential caps on rental payments and potential status as an unsecured creditor if the tenant rejects the lease each conflict with the credit support purpose of the master lease.

Re-characterization of the Master Lease as Guaranty

As described in this Section III, a master lease is typically used as a credit support mechanism in which the tenant is required to pay rent to the landlord for property that it does not occupy. A payment guaranty — absent the creation of an interest in real estate — is similar, as the guarantor is required to make payments to the holder of the guaranty as a matter of contract.

Accordingly, if a tenant defaults under a master lease, the landlord or tenant may attempt to characterize the lease as a guaranty. However, unlike well-drafted guarantees, it would be unlikely for a master lease to contain waivers of suretyship defenses, such as the obligation of the holder of the guaranty to mitigate damages and first exhaust recovery from other sources. Thus, if the tenant files for bankruptcy, the landlord may attempt to re-characterize the master lease as a guaranty to avoid a potential rejection of the master lease and the caps on recovery. In other contexts, the tenant may attempt to re-characterize the master lease as a guaranty in which the tenant has retained its suretyship defenses, or the landlord may attempt to re-characterize the master lease to avoid a tenant's rights as a tenant under state property law, each injecting uncertainty into the intended economic relationship between landlord and master tenant.[65]

Alternative (or Additional) Forms of Credit Support

A number of alternative types of credit support may be preferable to, or used in conjunction with, a master lease structure. Properly drafted payment and performance guarantees from a credit-worthy guarantor (with waivers of suretyship defenses) may support the income of a real estate asset yet avoid the creation of a landlord-tenant relationship. Similarly, cash escrows, holdback and standby letters of credit may provide alternative or additional methods to support real estate transactions.[66]

CONCLUSION

The flexibility of a master lease structure may help parties to consummate commercial real estate transactions by providing a mechanism to underpin the financial results of a real estate project; however, a number of legal and practical considerations must be evaluated.

While we have attempted in this paper to give the reader a general summary of relevant materials, each reader is advised to independently evaluate the applicability of the concepts described in this paper to any specific circumstance with the assistance of qualified counsel.

Notes

1 Unless otherwise noted, all "Section" references herein are to the Code.

2 Disclaimer: this article is intended to describe background principles in general terms. It does not, and is not intended to, provide legal, tax or regulatory advice and is not permitted to be relied upon by any party for any purpose. Readers should consult their legal and tax counsel and other advisers when analyzing any topic discussed herein.

3 Section 1031(a). Despite indications that Section 1031 was in danger of repeal, recent tax reform proposals have retained Section 1031 benefits, at least for real estate.

4 Teruya Bros., Ltd. v. Commissioner, 580 F.3d 1038, 1042 (9th Cir. 2009).

5 Section 1031(a)(1).

6 Section 1031(a)(3).

7 Section 1031(a)(1), (2); Treas. Reg. § 1.1031(a)-1(a).

8 Section 761(a).

9 See Bartell's Est. v. Commissioner, 147 TC 140, 161 (2016).

10 Treas. Reg. § 301.7701-1(a)(2) (partnership exists if co-owners of an apartment building lease space and, in addition, provide services to the occupants either directly or through an agent); Tim H. Cusick, 76 TC Memo 1998-286 (co-owners of rental real estate were partners despite never having filed partnership tax returns and the lack of a formal partnership agreement, where facts indicated the intent of parties, sharing of income and expenses, and business activity indicated the parties were properly characterized as partners in a partnership for tax purposes).

11 Rev. Proc. 2002-22, 2002-1 C.B. 733 (the "Revenue Procedure").

12 Id. at § 6.

13 H.R. Rep. No. 2020, 86th Cong., 2d. Sess., at 4 (1960), 1960-2 C.B. 119.

14 Sections 856(c)(2); 856(c)(5)(J)(ii).

15 Sections 856(c)(3); 856(c)(5)(J)(ii).

16 Treas. Reg. § 1.856-4(a)(1).

17 Section 856(d)(1)(C).

18 Section 856(d)(1)(B).

19 Treas. Reg. § 1.856-4(b)(1).

20 Treas. Reg. § 1.856-4(b)(1).

21 Treas. Reg. § 1.856-4(b)(1).

22 Section 865(d)(2)(A). The gross receipts rule is discussed in further detail below.

23 Section 856(d)(2)(B). The attribution rules of Section 318(a), as modified by Section 856(d)(5), apply in determining whether the requisite ownership percentage is met.

24 Section 856(d)(2)(C).

25 Section 856(d)(7).

26 The first lodging REIT went public in 1993, and many have followed.

27 See, e.g., PLR 9550019.

28 These provisions were part of the same legislative package that introduced TRSs to the tax law. See H.R. 1180, the Work Incentives Improvement Act of 1999, which contained the REIT Modernization Act. This legislation enabled nearly all REITs to form TRSs to perform substantial services to tenants. The advent of TRSs was one of the most dramatic developments and innovations in the history of the taxation of REITs. *See* Sections 541-71 of Pub. L. No. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999. Qualified health care properties were added to this regime in 2008 by Pub. L. No. 110-289.

29 A hotel will generally be a qualified lodging facility so long as no gambling occurs on premises. Nursing and assisted living facilities typically are "qualified health care properties," which are defined to include a "hospital, nursing facil-

ity, assisted living facility, congregate care facility, qualified continuing care facility… or other licensed facility which extends medical or nursing or ancillary services to patients." *See* Section 856(e)(6)(D)(ii).

30 Section 856(d)(8)(B). Section 856(d)(8)(A) contains a different exception (the "limited rental exception") which has proven useful for REITs and their TRSs. That exception is discussed briefly below.

31 Section 856(d)(9)(A).

32 Rent based on net income is not permitted under the REIT rules.

33 The other major exception allowing for a REIT to earn rents from a TRS relates to the operation of hotel and healthcare assets, described below.

34 See, e,g., PLR 201503010 (Jan. 16, 2015) (payments by TRS to REIT that owned storage facility for the rental of space needed to perform tenant services qualifies for the limited rental exception, even though the space is different than that rented by the REIT's storage customers, since the rental payments "will be arm›s-length and will be substantially comparable to rents paid by unrelated tenants for comparable space located in the same geographic area").

35 IRS guidance in other areas suggests that what constitutes "transient" for these purposes would be stays of thirty days or less.

36 PLR 200813005 involves a REIT that opted to hire a TRS or independent contractor to provide services instead of master leasing the property to an operator on a long-term basis.

37 In PLR 201628020, the IRS gave a favorable ruling to a REIT that rented parking space to a third-party owner of an adjacent building under a long-term lease. This ruling is significant because it was the first time that the IRS ruled favorably for a REIT that leased some (but not all) parking spaces in a garage.

38 See, e.g., Farmland Partners Inc., Prospectus as filed with the Securities and Exchange Commission (July 24,2014) ("We have leased, and intend to continue to lease, substantially all of our properties under leases with terms ranging from one to five years and pursuant to which the tenant is responsible for substantially all of the operating expenses related to the property, including taxes, maintenance, water usage and crop insurance…"), available at: https://www.sec.gov/Archives/edgar/data/1591670/000104746914006407/a2220909z424b4.htm.

39 See PLR 200428019 (March 25, 2004).

40 Section 856(d)(2)(A).

41 Treas. Reg. § 1.856-4(b)(3). The regulations allow for gross sales to be reduced by other adjustments as well, including "escalation receipts" between a prime tenant and its subtenants.

42 Id. See also PLR 201108009 (Feb. 25, 2011).

43 PLR 201337007.

44 Under Section 318(a)(3)(C), a corporation is considered to own the stock owned by any shareholder who owns, directly or indirectly, more than 50 percent of the value of that corporation›s stock. However, for purposes of determining whether rent qualifies as rents from real property, a 10 percent threshold is used. Without the shareholder restructuring, the Propco would have been treated as owning in excess of 10 percent of its tenant, the Opco, thereby disqualifying the master lease rents under the REIT rules.

45 See CareTrust REIT, Inc. Prospectus as filed with the Securities and Exchange Commission (Sept. 11, 2014), available at: https://www.sec.gov/Archives/edgar/data/1579877/000119312514232653/d735547ds4.htm.

46 See CBS Outdoor Americas Inc. Form S-4 as filed with the Securities and Exchange Commission (June 11, 2014), available at: https://www.sec.gov/Archives/edgar/data/1579877/000119312514232653/d735547ds4.htm.

47 See, e.g., Communications Sales & Leasing, Inc. Form S-11 as filed with the Securities and Exchange Commission (June 25, 2015), available at: https://www.sec.gov/Archives/edgar/data/1620280/000104746915005775/a2225209zs-11.htm#de40501_the_spin-off_and_related_transactions.

48 See Section 355(h); 856(c)(8), both enacted in 2015.

49 See Seritage Growth Properties Prospectus as filed with the Securities and Exchange Commission (June 9, 2015), available at: https://www.sec.gov/Archives/edgar/data/1628063/000119312515219435/d836914d424b3.htm#toc.

50 MGM Growth Properties LLC, Amendment 3. to Form S-11 as filed with the Securities and Exchange Commission (April 8, 2016), available at: https://www.sec.gov/Archives/edgar/data/1656936/000119312516534556/d63051ds11a.htm#toc63051_1.

51 In September 2017, MGM announced that the REIT will purchase the National Harbor property, which will be added to the master lease when the sale closes at the end of 2017. Press Release, MGM Resorts International And MGM Growth Properties LLC Announce Transaction On MGM National Harbor Casino Resort (Sept. 5, 2017), available at: http://mgmresorts.investorroom.com/2017-09-05-MGM-Resorts-International-And-MGM-Growth-Properties-LLC-Announce-Transaction-On-MGM-National-Harbor-Casino-Resort.

52 See, e.g., Gaming and Leisure Properties Inc., Annual Report (Form 10-K), at 23 (Mar. 25, 2014) («Rents received or accrued by GLPI from Penn or its subsidiaries will not be treated as qualifying rent for purposes of these requirements if the Master Lease is not respected as a true lease for U.S. federal income tax purposes and is instead treated as a service contract, joint venture or some other type of arrangement. If the Master Lease is not respected as a true lease for U.S. federal income tax purposes, GLPI may fail to qualify to be taxed as a REIT").

53 In some cases, the REIT opinion may explicitly rely on the conclusions reached in the true lease opinion. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561 (1978); American Realty Trust v. United States, 498 F.2d 1194 (4th Cir. 1974).

54 Amerco v. Commissioner, 82 T.C. 654 (1984). See also PLR 199940040 (July 13, 1999).

55 H.R. Rep. No. 432 (Part 2), 98th Cong., 2nd Sess. 1152-1156 (1984). See also Thomas R. Meagher, TC Memo 1977-270, August 15, 1977.

56 PLR 201525007 (June 9, 2015).

57 See Amerco, 82 T.C. 654 at 673 ("At first glance, one might think that our analysis and ultimate decision in Meagher would compel a decision in respondent›s favor in the instant case…However, the inquiry is inherently factual, and differences in the rights and duties of the parties may tip the scale in the opposite direction.").

58 Ground leases, sale/leaseback and credit tenant lease transactions can each be seen as a "master lease" structure; however, they are beyond the scope of this paper. A ground lease is a long-term lease by a master tenant of the land, paired with the tenant's fee ownership of the improvements on the land. The ground lessee acquires the improvements and pays rent to the fee owner for the land for the term of the lease. Upon the expiration of the term, the ground lease is terminated and the improvements revert to the fee owner. In a sale-leaseback, the owner and occupant of a real estate project generally desires to redeploy its capital by selling the project and entering into a long-term lease for the right to occupy the project for a specific term, thereby enabling the tenant to receive an influx of capital on the sale of the asset, potentially eliminate debt from its balance sheet and deduct its rent payments (see generally Rick Thomas, Pratt's Journal of Bankruptcy Law, Volume 9, Issue 6 (September 2013), Cross-Defaulted Leases in Bankruptcy: Integrated or Severable Agreements? A credit-tenant lease is a lease for an entire project from a credit-worthy tenant. Under the National Association of Insurance Commissioners guidelines, if a tenant is sufficiently credit-worthy and the lease contains sufficient impediments to termination by the tenant, the insurance company is permitted to a lower capital reserve requirement are reduced when compared to a commercial real estate loan, as the lender looks to the "credit tenant" for repayment as if the loan were a corporate bond rather than a secured real estate loan. See National Association of Insurance Commissioners' Model Laws, Regulations, and Guidelines, available at: http://www.naic.org/prod_serv_model_laws.htm.

59 See Edward J. Hannon, Real Estate Loan Workouts and Restructurings for Tenant in Common Owners, Freeborn & Peters LLP, copyright 2012-2013, available at: https://www.freeborn.com/assets/white_papers/freeborn_peters_white_paper-tic_workouts-2013-edward_hannon-_0.pdf.

60 See also Cheryl P. Armata, Lender Concerns About Master Leases, 24 No. 2 Prac. Real Est. Law. 59, March 2008.

61 For a general discussion, see Douglas P. Snyder, Master Leases in Financing Transactions, Real Property Trust & Estate Law, December 2006. See also 2 Illinois Real Property §12:17, Effect of Master Lease, copyright 2017. See also Douglas P. Snyder, Master Plans, Commercial Investment Real Estate Magazine, available at: https://www.ccim.com/cire-magazine/articles/master-plans/?gmSsoPc=1.

62 11 U.S.C. §365. If a lease is assumed in a bankruptcy proceeding, the debtor must cure any defaults and provide adequate assurance of future lease obligations.

63 11 U.S.C. §502(b)(6).

64 See Gregory G. Gosfield, Esq. and Kathleen Torbit, Esq., The Structure and Use of Real Estate Guaranties and Sureties, 2009-2010, available at: http://klehr.com/C7756B/assets/files/lawarticles/GGosfieldCLEdoc.pdf. See also Anthony J. Jacob, Aric T. Stienessen and Jeremy D. Duffy, Enforcing the Commercial Guaranty Agreement, Hinshaw & Culbertson LLP, available at: http://apps.americanbar.org/buslaw/blt/content/2012/01/0003a.pdf. An example of re-characterization can be found in a sale/leaseback transaction. If the seller/lessee files bankruptcy, the bankruptcy estate may attempt to re-characterize the sale/leaseback as a mortgage, on the grounds that the lessee, as the holder of a long-term tenancy right and a right to purchase the fee, is economically equivalent to an owner of the fee interest subject to a mortgage (the obligation to make debt payments). A landlord is likely in a better position in a bankruptcy than a mortgagee. In a bankruptcy proceeding, if a tenant assumes a lease, the tenant must cure defaults and provide adequate assurance of performance of future obligations under the lease, whereas, a secured creditor may have the terms of its mortgage modified by the bankruptcy court so long as it receives payments with a present value equal to the value of its interest in the collateral, as determined by the court. See generally Marshall E. Tracht, Leasehold Recharacterization in Bankruptcy: A Review and Critique, New York Law School Legal Studies, Research Paper Series 12/13 #42 (2013).

65 See Gosfield et al., page 57.