United States

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1. Introduction

Real estate investment trusts (REITs) were first introduced in 1960, when the Internal Revenue Code[1] was amended with the addition of Sections 856 through 860,[2] which provide for the definition and tax treatment of these specialised investment vehicles. REITs were conceived of as mutual funds for real estate investment. For many years prior to the advent of REITs, mutual funds and other forms of widely held, regulated investment companies had provided a means by which large numbers of small investors could pool their capital, giving them collective access to professional investment advice as well as investment opportunities that would not otherwise have been available to them. REITs were added to the code in order to provide similar opportunities for pooled investment in real estate, an asset class to which the small investor had even less access than publicly traded securities.[3] Congress noted a particular need in this area because of a shortage in available public capital for the real estate industry, which was being financed to a significant extent by government guaranteed debt and large institutional investors.[4]

The cornerstone of the concept was to provide for a single level of tax on income and gains derived through this investment vehicle. The United States had then, as it does now, a two-tier system of taxation. Corporations pay tax on their income and gains, and shareholders pay tax once again when such income and gains, net of corporate tax, are distributed as dividends. Regulated investment companies represented an exception to that rule, in that an entity qualifying as a regulated investment company could get a deduction against its taxable income for dividends paid to its shareholders. Thus, if it distributed out all of its earnings, it would have no corporate level tax to pay, leaving taxation to the shareholder level. The fundamental concept for REITs was the same: as long as they paid their income and gain out to shareholders, they too would have no corporate-level tax.[5]

In order to be eligible for this special treatment, REITs, like regulated investment companies, had to meet stringent standards. First, a REIT, like a regulated investment company, had to be widely held, underscoring the fact that REITs were designed to serve as a pool for a small investors, not a tax-advantaged vehicle for large investors.[6] Second, again borrowing from the regulated investment company statutory scheme, substantially all (90%) of the REIT's taxable income had to be from passive sources and 75% had to be from passive real estate investments, underscoring the passive investment, as opposed to active business, focus of the REIT.[7] Third, asset tests were applied equivalent to those for regulated investment companies to ensure wide

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diversification of holdings in non-real estate passive investments.[8] However, the rules did not require diversification of real estate holdings, recognising that users of capital in the real estate market did not have the ability to access large numbers of investors in a manner equivalent to issuers of debt and equity securities in the public markets.

In the more than 45 years since the REIT rules were first enacted, REITs have become enormously popular vehicles for public and private investment in real estate. REITs have been through booms and busts; sophisticated strategies for use of REITs have evolved over time; and experience has led Congress and the US Internal Revenue Service (IRS) to recognise and adapt to developments in the marketplace, so that REITs are not a static statutory concept, but real creatures of the marketplace.

2. Nature of legal entity

A REIT must be organised as a corporation, trust or association, as such terms are defined for US federal tax purposes.[9] During the early years, REITs were generally organised as Massachusetts business trusts, because only a trust or unincorporated association could qualify as a REIT prior to a 1976 amendment to the code[10] and because Massachusetts had well-developed common law business trust rules.[11] Following the advent of statutory business trust rules, particularly in Delaware and Maryland, REITs in the form of business trusts are often organised outside of Massachusetts. Nevertheless, corporate form seems to be the leading choice, with over 70% of publicly traded REITs organised as state law corporations at present.[12]

The code requires that, but for the REIT provisions of the code,[13] a REIT must be taxable as a domestic corporation.[14] In this context, 'domestic' means created or organised in the United States or under the law of the United States or of any state.[15] State-law corporations are *per se* domestic corporations. If an entity that is not a *per se* domestic corporation (eg, a domestic business trust, partnership or limited liability company) makes an election to be treated as a REIT under the code, it is deemed to have made an election to be treated as an association taxable as a corporation for purposes of federal taxation.[16] The code further requires that a REIT may not be a financial institution or an insurance company.[17]

2.1 UPREITs

Many REITs currently in operation are structured as umbrella partnership real estate investment trusts (UPREITs). An UPREIT is a REIT that holds its properties through a partnership ('operating partnership') in which the REIT is a partner, ordinarily with the controlling interest. The first UPREITs were developed in the early 1990s to provide a way for real estate property owners to contribute their appreciated assets to REITs without incurring immediate taxation.[18] In many instances, a newly formed REIT will transfer cash raised in an initial public offering (IPO) to an operating partnership in exchange for a general partnership interest. The operating partnership, in turn, will acquire real estate from contributing partners, either directly or through subsidiary partnership or limited liability companies, in exchange for limited partnership interests in the operating partnership. This contribution can be structured on a tax-deferred basis under the partnership rules of the Internal Revenue Code.[19] The operating partnership might use the cash contributed by the REIT to pay down

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liabilities on the contributed properties, purchase additional properties or pay ongoing operating expenses. The partnership agreement of the operating partnership usually provides that units of interest in the limited partnership may be converted into stock of the REIT on a one-for-one basis after a waiting period, typically one to two years. However, such conversion of a limited partnership interest in the operating partnership to REIT stock is fully taxable, and is usually undertaken when the unitholder expects to sell the shares of the REIT after conversion.

2.2 DownREIT

A downREIT is a structure developed to enable REITs that are not organised as UPREITs to compete effectively with UPREITs in acquiring properties. In a downREIT, an existing REIT and a property owner form a partnership to hold the contributed property. The REIT contributes cash to the partnership in exchange for a general partnership interest, and the property owner contributes property in exchange for a limited partnership interest which may be converted into REIT stock at some future date. Because limited partners in a downREIT structure generally have interests only in the partnerships that hold the properties they contributed, and not in an operating partnership that holds all REIT assets, the conversion of a limited partnership interest into REIT shares is based on the ratio of the fair market value of the property contributed to the value of the REIT shares. The contribution of appreciated property by the owner does not result in immediate taxation, and the cash contributed by the REIT is usually used to pay down debt encumbering the property.

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2. Relevant legislation

An entity that elects to be treated as a REIT must comply with the REIT provisions of the Internal Revenue Code contained in Sections 856 through 860 and certain excise tax rules contained in Section 4981. Within the provisions of the Foreign Investment in Real Property Tax Act of 1980,[20] there are special rules dealing with the taxation of foreign shareholders of REITs. Finally, the corporate taxation rules of the Internal Revenue Code apply to REITs to the extent such rules are not inconsistent with the REIT provisions of the code.[21]

3. Status

Although REITs are subject to shareholder tests,[22] there is no requirement that they be either public or private. There are approximately 200 publicly traded REITs in existence,[23] and the number of private REITs is undoubtedly many times that figure. There are no federal tax rules requiring REITs to be open ended or closed ended. Although REITs ordinarily do not have a programme in place to redeem their shares upon investor request and do not have a programme for continuous offering of their shares, REITs often engage in subsequent share offerings to raise additional capital after their IPO.

4. Nature of investor base

4.1 One hundred or more shareholders

The beneficial ownership of a REIT must be held by 100 or more persons for 335 days of a full taxable year or a proportionate portion of a shorter taxable year.[24] However, this requirement is waived for the first REIT taxable year.[25] Whether the beneficial ownership of an entity is held by 100 or more persons is determined without reference to any rules of attribution.[26] In this context, the term 'person' has the same meaning as it has for purposes of the US Investment Company Act of 1940, as amended,[27] and includes, among others, a natural person, a corporation, a partnership, an association, a joint stock company and a trust.[28] To qualify as a beneficial owner for this purpose, a person must purchase REIT shares or interests at a purchase price that is not nominal.[29]

4.2 Not closely held

REITs were intended to be mutual funds for real estate, making investment in this asset class accessible to the investing public and not just the privileged few. Accordingly, since inception, the REIT rules have been designed to deny the benefits of the regime to concentrated groups of individual investors. The code requires that not more than 50% in value of the REIT's stock may be owned, directly or through attribution, by five or fewer individuals during the last half of each taxable year.[30] For purposes of this test, private foundations and other specified entities (or portions of entities) are treated as individuals.[31] Extensive attribution rules operate to aggregate ownership to prevent the use of related parties to avoid the 'not closely held' test. The applicable attribution rules generally provide that stock owned by a corporation, partnership, estate or trust must be considered as owned proportionately by its shareholders, partners or beneficiaries.[32] In addition, if the effect is to cause an entity to be closely held:

- an individual is considered as owning stock owned by his siblings, spouse, ancestors and lineal descendants; and
- a person is also treated as owning stock that such person has an option to acquire, including pursuant to ownership of convertible debt.[33]

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In addition, a REIT treats any stock held by a qualified trust[34] as held directly by its beneficiaries in proportion to their actuarial interest in such trust unless, with respect to such trust, one or more fiduciaries, employers or other disqualified persons hold in the aggregate 5% or more in value of the interests in the REIT and such REIT has accumulated earnings and profits attributable to any period for which it did not qualify as a REIT.[35] However, if a REIT relies on this look-through rule to qualify as 'not closely held' for a taxable year, under some circumstances these trusts could be subject to unfavourable tax treatment as described at section 13.2(b) below.

To prevent an inadvertent violation of the 'not closely held' requirement and 100 shareholder requirement described above, REITs often adopt 'excess share provisions' in their organisational documents. Pursuant to an excess share provision, if a shareholder attempts to transfer shares the effect of which would result in a violation of the restrictions prescribed in the provision, such transfer will be void and the shares may be deemed transferred to a trust, which will hold the shares for the benefit of a

charitable beneficiary pending a transfer to a person whose ownership will not violate the restrictions.

Like the 100 shareholder rule, the five-or-fewer rule is waived for the first REIT taxable year.[36] To take full advantage of the first-year waiver, a REIT should carefully choose the timing of a REIT election. In some cases, it might be advantageous for a newly organised entity that has raised money late in the taxable year, for example, to wait until the second year after its formation to make its REIT election in order to get the full benefit of the one-year waiver.

4.3 Transferability of REIT shares or interests

The beneficial ownership of a REIT must be evidenced by transferable shares or by transferable certificates of beneficial interest.[37] Some practitioners hold the view that this rule was intended to make clear that interests in a business trust, which are not, as a matter of law, transferable, must be no less transferable than corporate shares. Nonetheless, the US Treasury Department and the IRS have taken a more restrictive view of this provision, generally prohibiting charter restrictions on transfers with certain clear exceptions. Under the REIT rules themselves, provisions in the organisational documents which permit the trustees or directors to redeem shares or to refuse to transfer shares in any case where the trustees or directors, in good faith, believe that a failure to redeem shares or that a transfer of shares would result in the loss of status as a REIT will not render the shares 'non-transferable'.[38] In addition, the IRS has privately ruled that a REIT did not violate the requirement of transferable shares when it incorporated in its organisational document provisions that treat a transfer as void if such transfer:

- violates an applicable jurisdiction's securities laws or regulations;
- will result in the loss of REIT status; or
- will result in the REIT's failure to qualify as a domestically controlled REIT.[39]

Furthermore, the IRS has privately ruled that a REIT does not fail to satisfy the transferability requirement if:

- it issues shares pursuant to an employee stock incentive plan, which are subject to transfer restrictions or possible forfeiture prior to vesting;[40]
- its organisational document includes 'excess share provisions' designed to prevent a violation of the '100 shareholder' and 'not closely held' requirements;[41] and
- it adopts restrictions on the amount of stock a shareholder may own in order to prevent an ownership change that results in undesirable limitations on net operating loss carry-forwards and certain built-in losses.[42]

5. Management

5.1 Management by directors or trustees

A REIT must be managed by one or more trustees or directors.[43] In the case of a REIT organised as a business trust, the trustees must be vested with management authority that resembles, in powers and functions, the directors of a statutory corporation, and

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