EPRA | REPORTING

European Public Real Estate Association

# Global REIT Survey 2016

AMERICAS

# USA – US-REIT

A COMPARISON OF THE MAJOR REIT REGIMES AROUND THE WORLD

# 1 General introduction

| | Enacted year | Citation | REIT type |
|---|---|---|---|
| US-REIT | 1960 | Internal Revenue Code | Corporate type |

The US Congress created the Real Estate Investment Trust (US-REIT) in 1960 in order to make large-scale, income-producing real estate investments accessible to smaller investors. Congress reasoned that the average investor should be able to invest in large-scale commercial properties just as if it were any other kind of investment, that is, through the purchase of equity. Similar to shareholders benefiting from the ownership of stocks in other corporations, the stockholders of a REIT also receive economic benefits from the production of income through commercial real estate ownership. REITs offer distinct advantages for investors. Firstly, greater diversification is achieved by investing in a portfolio of properties rather than just in a single property. Second, the managerial activities are performed by experienced real estate professionals. Also, in order not to be subject to a corporate-level tax REITs are required to distribute all of their taxable income to shareholders, who benefit from this stream of cash distributions.

### Sector summary*

| Listing Country | Number of REITs | Number in EPRA REIT Index | Sector mkt cap (EUR€m) | % of Global REIT Index |
|---|---|---|---|---|
| United States | 220 | 130 | € 986.770 | 65.19% |

*Data provided by NAREIT (converted to EUR)

### Top five REITs*

| Company name | Mkt Cap (EUR€m) | 1 yr return (EUR€) % | Div Yield | % of Global REIT Index |
|---|---|---|---|---|
| Simon Property Group | € 60.966 | 24.66% | 2.82% | 5.54% |
| Public Storage | € 35.921 | 19.81% | 3.01% | 2.74% |
| Prologis | € 25.538 | 38.22% | 3.08% | 2.32% |
| Welltower Inc. | € 25.101 | 19.22% | 4.34% | 2.28% |
| General Growth Properties | € 24.318 | 20.49% | 2.38% | 1.26% |

*All market caps and returns are rebased in EUR and are correct as at 29 July 2016. The Global REIT Index is the FTSE EPRA/NAREIT Global REITs Index. EPRA, August 2016.

The US REIT regime, which is governed by tax laws, has been modified on several occasions since its inception, most recently in the PATH Act as signed into law on Dec. 18, 2015. The essential rules for the US REIT can be found in section 856 and 857 of the Internal Revenue Code.

# 2 Requirements

## 2.1 Formalities / procedure

| Key requirements |
|---|
| Entities must file Form 1120-REIT with the Internal Revenue Service. |

To elect REIT status in the US, a company must file a special tax return (Form 1120-REIT) for the year in which the company wishes to become an REIT. There is no requirement to request prior approval or to submit prior notification of regime election. Furthermore, the REIT must annually send letters of record to its shareholders requesting the details of the beneficial share ownership. Modest monetary penalties may be imposed on a REIT that fails to send these letters unless it is shown that a failure is due reasonable cause and not willful neglect.

## 2.2 Legal form / minimum share capital

| Legal form | Minimum share capital |
|---|---|
| Any legal US entity taxable as a domestic corporation. | No |

### Legal form

A US REIT can have the form of any legal US entity (corporation, partnership, business trust, limited liability company, etc), which is taxable as a domestic corporation. This status can be achieved by a 'check the box' election with the IRS. As a result, the entity would be treated as a corporation for tax purposes. However, the company cannot qualify for this option if it is a financial institution such as a bank or an insurance company.

Further requirements are that the REIT has to be managed by one or more trustees or directors, and that the shares of a US REIT must be transferable.

A taxable REIT subsidiary is permitted to be located or organised abroad.

### Minimum share capital

There is no minimum share capital requirement for a REIT.

## 2.3 Shareholder requirements / listing requirements

| Shareholder requirements | Listing mandatory |
|---|---|
| - At least 100 shareholders.<br>- Five or fewer individuals or foundations may not hold more than 50% of the shares.<br>- No restriction on foreign shareholders. | No |

### Shareholder requirements

Firstly, REIT shares must be transferable. Beginning with the REIT's second taxable year, the REIT is required to have a minimum of 100 shareholders. Also, no more than 50% of its shares may be held by five or fewer individuals or private foundations during the last half of the taxable year. A number of 'look through' rules can determine whether the latter criterion is met.

Various stock classifications (i.e. different classes of shares such as common stock and preferred stock) are allowed. However, all shareholders within the same class of stock must be treated

equally. Otherwise, dividends from such classes of stock would no longer be considered eligible for the dividends paid deduction. In December 2015, legislation was enacted (effective January 1, 2015) that repealed these so-called “preferential dividend” rules for all “publicly offered” REITs (REITs whose securities are registered with the SEC) US REITs. Further, the legislation provided the Treasury Department with the express authority to cure inadvertent failures of the preferential rules by non-publicly offered REITs.

No restriction on foreign shareholders other than possible ‘FIRPTA’ consequences, under which foreign shareholders are treated as doing business in the US, unless certain exceptions apply.

**Listing requirements**

Listing is not mandatory to obtain REIT status. A private REIT is allowed.

## 2.4 Asset level / activity test

| Restrictions on activities / investments |
| --- |
| - At least 75% of its assets must be real estate, government securities or cash<br>- 75% asset test and 75% and 95% income tests.<br>- Cannot own more than 10% of another corporation’s stock, other than in another REIT or a taxable REIT subsidiary (ownership of a 100% owned ‘qualified REIT’ subsidiary is ignored).<br>- No more than 5% of the value of its assets can be represented by securities of any one issuer, other than another REIT or a taxable REIT subsidiary (ownership of a 100% owned ‘qualified REIT’ subsidiary is ignored).<br>- Cannot own more 25% (20% starting in 2018) of its assets in securities of one or more taxable REIT subsidiaries. |

75% of a REIT’s assets must be comprised of real estate (including mortgages), government securities or cash items (including money market funds). In 2014, the IRS issued proposed regulations concerning the definition of real estate. In general, these regulations attempt to clarify the appropriate analysis for determining whether an asset is real estate. They would provide that land, inherently permanent structures, and structural components are real estate for purposes of this 75% asset test rule. In addition, they provide a set of *per se* examples of assets that are considered real estate, and they set forth a facts and circumstances test as well as a set of examples for assets that are not *per se* real property.

In particular, parking facilities; bridges; tunnels; roadbeds; railroad tracks; transmission lines; pipelines; and fences would be considered inherently permanent structures that are real estate, and wiring; plumbing systems; central heating and air conditioning systems; elevators or escalators; walls; floors; ceilings; permanent coverings of walls, floors, and ceilings; windows; doors; insulation; chimneys; fire suppression systems, such as sprinkler systems and fire alarms; fire escapes; central refrigeration systems; integrated security systems; and humidity control systems would be considered structural components that are real property.

At least 75% of the gross income must be derived from real estate property rental or from interest on mortgages on real estate property. Furthermore, at least 95% of the gross income must come from a combination of real estate related sources and passive sources, such as dividends and interest. No more than 5% of a REIT’s income may come from non-qualifying sources.

At the end of each quarter, the REIT may not have securities of taxable REIT subsidiaries that represent more than 25% (20% starting in 2018) of the REIT’s total asset value. Further restrictions apply. As part of renting real estate, a REIT is allowed to provide all kinds of tenant services expected in the real estate rental business. Services are broad and extensive, e.g. providing utilities (sub-metering), security services, cleaning services in common areas, internet and cable TV, etc.

A US REIT is allowed to own, operate, manage and develop real estate for its own portfolio. If it develops real estate for third parties, the resulting income is disqualified and must fit under the 5%

'bad income' allowance. US REITs may develop real estate for third parties or trade real estate through their taxable REIT subsidiaries (TRS).

A REIT is allowed to invest in non-US real estate assets, which are considered real estate under the 75% asset test.

A REIT's ownership interests in a partnership are ignored. Instead, the REIT is considered an owner of the partnership's assets to the extent of the REIT's capital interest in the partnership. Also, the ownership of one REIT by another REIT is considered the ownership of real estate, i.e. a good asset. If the REIT is a shareholder of a company other than another REIT or a TRS, then the REIT cannot own more than 10% of the shares. Further, the REIT may have no more than 5% of its total assets represented by securities of any one issuer other than another REIT or a TRS.

## 2.5 Leverage

| Leverage |
| --- |
| No legal restrictions. |

There are no statutory or regulatory leverage limits for US REITs.

## 2.6 Profit distribution obligations

| Operative income | Capital gains | Timing |
| --- | --- | --- |
| At least 90% of its taxable ordinary income. | Not required to distribute. | Annually. |

### Operative income

US law requires the REIT to annually distribute at least 90% of its ordinary taxable income in form of dividends. If an REIT declares a dividend in the last quarter of the year, but pays it by the end of January, the dividend distribution is treated as if it had occurred the previous December. These "relationship back-rules" apply if the REIT makes the actual distribution the following year. However, a 4% excise tax is imposed if the REIT fails to distribute at least 85% of its income within the year the income is generated.

### Capital gains

US REITs are not required to distribute capital gains. Capital gains not distributed are subject to corporate income tax, but then the shareholders get an increased tax basis for their pro rata share of the tax.

## 2.7 Sanctions

| Penalties / loss of status rules |
| --- |
| - Various penalties.<br>- Possible loss of REIT status. |

Various penalties may occur. If insufficient income was distributed, the REIT may compensate with taxable deficiency dividends. If the REIT fails a *de minimus* amount of the asset test, it must fix the failure within six months of discovery. If the REIT fails the asset test by more than a *de minimus* amount, the REIT must pay corporate taxes on all income from non-qualified assets. In this case, it must also show reasonable cause for the failure. A USD 50,000 penalty is imposed for failures other than the asset test failures. Reasonable cause must also be proven in such cases. If there is no

reasonable cause, then the REIT may technically lose its REIT status. Usually, however, the IRS will consider a closing agreement for some lesser amount.

If the REIT fails either the 75% or 95% gross income tests, it is subject to a penalty essentially equal to 100% of the amount by which it failed the respective tests, less allocable deductions.

After the loss of REIT status, the entity must observe a five-year waiting period before it can re-apply. The government may waive this penalty, depending on the reasonable cause.

A USD 50,000 penalty is imposed if the REIT shareholder limitations are disregarded.

# 3 Tax treatment at level of the REIT

## 3.1 Corporate tax / withholding tax

| Current income | Capital gains | Withholding tax |
|---|---|---|
| Tax-exempt to extent distributed. | Tax-exempt to extent distributed. | - No refund of foreign withholding tax.<br>- It can use a foreign tax as deduction. |

### Current income
Distributed dividends are deducted in calculating a REIT’s taxable income. Retained income is subject to ordinary corporate income tax, but tax depreciation deductions are made in calculating taxable income. Dividends from ordinary income are generally taxed as ordinary dividends. The profits of a taxable subsidiary are subject to corporate income tax.

A REIT that acts as a dealer, as contrasted with an investor, is subject to a 100% excise tax on the profit from dealer sales. There is a safe harbor under which a REIT can be certain it will not be subject to the 100% excise tax if it complies with multiple objective tests.

Non arms-length transactions conducted with a taxable REIT subsidiary (as well as non-arm’s length transactions between a TRS and a REIT’s tenants) are 100% taxable.

### Capital gains
Retained capital gains are subject to corporate income tax.

### Withholding tax
A US REIT is not entitled to obtain a refund for its foreign withholding tax credit. The credit applies to its foreign source income. However, it can use a foreign tax as a deduction.

### Other taxes
State income tax regimes virtually always follow the federal income tax rules.

### Accounting rules
US GAAP rules apply. A US REIT and its subsidiaries must file a consolidated financial statement.

### 3.2 Transition regulations

| Conversion into REIT status |
| --- |
| - 'Built-in gains' are taxable.<br>- Exemption is possible if assets held for ten years. |

By the end of the REIT's first taxable year, the REIT must distribute all the earnings and profits for years before it became an REIT. Also, the REIT must pay a corporate tax on 'built-in gains' (the value of its assets at the time of REIT conversion minus the assets' tax basis). The taxes may be excused only if the REIT does not sell or exchange those assets in a taxable transaction for five years (but temporary regulations raise this to 10 years after August 2016), and it does not enter into any taxable transactions with respect to these assets during the ten-year period. 'Like kind' exchanges in which no built in gain occurs are permitted.

Many REITs use an UPREIT structure, which means 'Umbrella Partnership'. Under this structure, the REIT's sole asset is its interest in a partnership called the 'Operating Partnership' (OP). The REIT almost always has the general partner interest and typically owns more than half of the partnership interests. Property owners transfer either their assets or partnership interests to the OP in exchange for limited partnership interests (LP Units). As with any other transfer to a partnership, the contribution of these assets, or other partnership interests, is a tax-deferred transaction in which gain is not realised until the transferor's debt obligations shift or the transferor disposes the partnership interest in a taxable transaction. Usually after a year, the OP limited partners may exchange their OP Units either to the REIT or the OP (depending on the particular transaction), and then the REIT or the OP, as the case may be, has the option of either transferring to the LP Unit holder REIT stock on a one-for-one basis with each Unit the LP Unit owner exchanges, or cash equal to the fair market value of such stock. The exchange of the LP Units for REIT stock or cash is a taxable transaction.

### 3.3 Registration duties

| Registration duties |
| --- |
| Transfer tax. |

Real estate acquisition is usually subject to transfer taxes in most states.

# 4 Tax treatment at the shareholder's level

### 4.1 Domestic shareholder

| Corporate shareholder | Individual shareholder | Withholding tax |
| --- | --- | --- |
| Income, capital gains, and return of capital distributions are taxed at a rate of 35%. | - Capital gain dividends are taxed at the maximum 23.8% rate.<br>- Return of capital is tax-deferred. | N/A |

**Corporate shareholder**

US corporations pay the same 35% rate on REIT capital gains and REIT ordinary income distributions. Corporate shareholders do not receive typical dividends received deduction with respect to REIT dividends. The return of capital distribution reduces the shareholder's tax basis in its shares of the REIT.

### Individual shareholder

An individual US shareholder is subject to an income tax of up to 39.6%. An additional 3.8% surtax on investment income for taxpayers with adjusted gross income in excess of USD 200,000 (USD 250,000 for taxpayers who file a tax return as a married couple) also is applicable.

REIT ordinary dividends qualify for the lower 20% rate on “qualified dividends” (plus the 3.8% surtax, if applicable) only if they are paid out of income that has already been subject to corporate taxes, e.g. dividends attributable to distributions from a taxable REIT subsidiary. The top marginal rate on dividends other than “qualified dividends” is 43.4%.

Shareholders are taxed on capital gain distributions from assets the REIT held for at least one year at a 23.8% rate (including the 3.8% surtax). However, if the gain is attributable to the recapture of depreciation, the tax burden is 28.8%, including the surtax.

Return of capital distributions reduce the shareholder’s tax basis and are therefore tax-deferred. To the extent a return of capital distribution exceeds tax basis, it is treated as sale of the stock and the gain is taxable at the 23.8% maximum rate (including the 3.8% surtax). (The return of capital rules for a REIT are the same as for non-REIT corporations).

### Withholding tax

No withholding tax is levied on distributions to US shareholders.

## 4.2 Foreign shareholders

| Corporate shareholders | Individual shareholders | Withholding tax |
|---|---|---|
| - 30% on income dividends.<br>- 35% on capital gain dividends.<br>- 10% on return of capital. | - 30% on income dividends.<br>- 35% on capital gain dividends.<br>- 10% on return of capital. | Tax treaty relief available. |

### Corporate shareholders

Final withholding tax.

### Individual shareholders

Final withholding tax.

### Withholding tax

A withholding tax of 30% is levied on income dividends. This rate may be reduced by a double tax treaty. The US usually imposes a 15% tax on dividends paid by REITs in countries with which the US has a valid double tax treaty. The amount of the repayment of capital which is not subject to a withholding tax is taxed at a rate of 10%. The rate returns to 30% in most treaties for foreign shareholders who own more than 10% of a REIT. Non-US pension funds and certain governmental entities such as sovereign wealth funds might benefit from a tax exemption.

Capital gain dividends attributable to the sale of US real property are subject to the Foreign Investment in Real Property Tax Act (FIRPTA). According to FIRPTA, foreign shareholders are treated as if they were US taxpayers. Unless the shareholder owns 5% (10% after Dec. 18, 2015) or less of a listed REIT, the capital gain dividends are subject to a 35% (plus branch profit tax) withholding tax. If the shareholder does own 5%/10% or less of the REIT shares, then the treatment of capital gain dividends is similar to the treatment of ordinary dividends. Legislation enacted on Dec. 18,2015exempts foreign pension plans from FIRPTA, although there are a number of interpretative issues that remain to apply this exemption that should be addressed by regulatory guidance.

A return of capital distribution is subject to 10% withholding tax. If a withholding certificate is obtained, 0%.

Sales of stock of a listed US real estate company (if the non-US shareholder owns 5%/10% or less of the REIT) or of any domestically controlled REIT are not subject to FIRPTA or any US tax.

# 5 Treatment of foreign REITs and their domestic shareholders

| Foreign REIT | Corporate shareholder | Individual shareholder |
|---|---|---|
| Generally 30% withholding tax. | - Dividend distributions are taxed at a rate of 35%.<br>- Return of capital is tax deferred. | - Dividends are generally taxed at a maximum 23.8% rate if foreign REIT is not a 'PFIC'.<br>- Return of capital is tax-deferred. |

**Foreign REIT**

Unless the foreign REIT elects to be taxed on a net basis, or is actively operating rental property so that it is considered doing business in the US, there is a 30% withholding tax on gross rental income. Most non-US investors filing as a US business heavily leverage to reduce US taxable income.

**Corporate shareholder**

US corporate shareholders generally are taxable at a 35% rate on distributions from foreign REITs. The return of capital distribution reduces the shareholder's tax basis in its shares of the REIT. Furthermore, there is no credit available to US corporate shareholders for US withholding taxes paid by the foreign REIT with respect to US source income. Generally, these dividends are not eligible for the dividends received deduction applicable to dividends from US corporations.

Finally, if the foreign REIT is considered a 'passive foreign investment company' (PFIC), which may be the case if the rental income of the foreign REIT is not attributable to the activities of its own employees, a US shareholder either is subject to tax and substantial interest charges upon receipt of a distribution from the PFIC (or disposition of the PFIC stock), or may elect instead to be taxed on the PFIC investment on a current basis using an earnings flow-through approach or a mark-to-market approach.

**Individual shareholder**

An individual US shareholder is generally subject to an income tax at the maximum rate of 23.8% (including the 3.8% surtax noted above) on dividends distributed by a foreign REIT if the foreign REIT is both eligible for treaty benefits under a US tax treaty and is not a PFIC, as described above (although the maximum withholding tax rate with respect to REIT dividends under most treaties is 15%). Return of capital distributions reduce the shareholder's tax basis and are therefore tax-deferred. To the extent a return of capital distribution exceeds tax basis, it is treated as sale of the stock and the gain is taxable at the 23.8% maximum rate (including the 3.8% surtax). The return of capital rules for a REIT are the same as for non-REIT corporations. Furthermore, there is no credit available to a US individual shareholder for US withholding taxes paid by the foreign REIT with respect to US source income.

If the foreign REIT is considered a PFIC, which may be the case if the rental income of the foreign REIT is not attributable to the activities of its own employees, an individual US shareholder either is subject to tax at rates of up to 43.4% (including the 3.8% surtax noted above) and substantial interest charges upon receipt of a distribution from the PFIC (or disposition of the PFIC stock), or may elect instead to be taxed on the PFIC investment on a current basis using an earnings flow-through approach or a mark-to-market approach. ■

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