



reit spotlight

Real estate investment trusts (REITs) and development: Avoiding qualification woes

Richard Cunningham, Jr.
Hirschler
Fleischer

J.M. Ramey, III
Hirschler
Fleischer

As acquisition cap rates have declined over the last few years, many real estate investment trusts (REITs), public and private, have turned to development as a core piece of their investment strategy.¹ Development may take the form of new construction on raw land or redevelopments or build outs of existing properties owned by the REIT. REITs must be careful, though, to avoid some of the REIT tax qualification issues that may arise with development activities.

Affiliated

Development Services

REITs must meet certain income tests in order to maintain status as a REIT for federal income tax purposes. REITs must ensure that at least 75% of REIT gross income arises from real-estate related investments and that at least 95% of REIT gross income arises from these investments, dividends and other interest income. Income from certain non-customary services can give rise to "bad income," which could trigger qualification problems if aggregate bad income exceeds 5% of REIT gross income. Development activities, from which the REIT or an affiliate of the REIT receives income, may fall within these non-customary services and contribute to the REIT's bad income basket.

A REIT may avoid bad income associated with development activities in certain instances. The Internal Revenue Service (IRS), through private letter rulings, has allowed REITs and their affiliates to provide limited development services for tenants without causing otherwise qualifying rents to be treated as bad income for the REIT income tests.² These private letter rulings are authority only for the taxpayer requesting the ruling and do not bind

the IRS. However, they do suggest strategies REITs or their affiliates may use to structure their development activities that will be REIT compliant.

An advisor to the REIT or one of the REIT's affiliates may perform construction management services in connection with the development of the REIT's property and receive a fee for its services. The IRS, in a private letter ruling, has stated that these services should be limited to:

- Pricing estimates and cost analysis.
- Negotiating and contracting for engineering and feasibility studies.
- Arranging for zoning and building permits.
- Employing and supervising architects and contractors.
- Assisting in the layout and design of tenant space.
- Approving and processing invoices and disbursing funds.
- Ordering building materials and supplies.
- Inspecting and approving plans and work performed for aesthetic factors, effect on property values and compliance with laws and regulations.
- Working with engineers, consultants, contractors and governmental agencies to prevent, detect and remedy environmental contamination.³

Physical and more hands-on construction activities are not previously listed. Although one private letter ruling allowed a REIT or its employees to perform physical construction services,⁴ the clearer line of authority indicates physical construction should be performed by an independent contractor,⁵ and not by the REIT or its affiliates. An independent contractor for this pur-

pose is a person that neither owns a significant interest in the REIT nor is itself owned by persons who also own a significant interest in the REIT.

A REIT may cleanse otherwise bad income by forming a taxable REIT subsidiary to perform the development services. The REIT Modernization Act of 1999 broadened a REIT's ability to undertake its own development activities, soup to nuts and bolts, as long as the income generated by development activities is taxed at the subsidiary level prior to being distributed to the parent REIT. A REIT may even develop properties to be held for sale or perform development activities for third parties through its taxable REIT subsidiary. The dearth of recent private letter rulings or other authorities on REIT development income may be attributable to the increased use of a taxable REIT subsidiary to conduct these activities.

Note that there are limitations on the use of a taxable REIT subsidiary for this purpose. Under these limitations, the amount of a REIT's development activities is restricted in relation to the size of its real estate holdings because the value of all taxable REIT subsidiaries of a REIT may not represent more than 20% of the REIT's gross assets on a consolidated basis.

Sources of

Development Funds

When undertaking a real estate development project, REIT management should carefully consider the sources of funding for the project. In order to maintain its tax status as a REIT, the REIT must distribute at least 90% of REIT taxable income for the taxable year (excluding net capital gains).⁶ Failure to do so will result in the REIT being taxed as a C corporation for such year and possible subsequent years if REIT status is terminated and the circumstance causing such termination is not timely cured. Further, to the extent that the REIT does not make distributions in an amount at least equal to 100% of its taxable income, the REIT will be taxed on such undistributed portion at income tax rates applicable to a C corporation.

Taxable income for distribution purposes will include net income from the operation of its properties during the taxable year. The REIT will be required to distribute at least 90% of this amount to its shareholders to preserve its status as a REIT, and will not be able to use this amount to fund other uses, including acquisitions, developments or other forms of reinvestment. The REIT will require other financing sources to fund its development activities.

Funds from the issuance of equity and debt securities may be used in such a manner and income from the temporary investment of new capital will satisfy the REIT income tests.⁷ "New capital" means any amount received by a REIT (a) in exchange for the stock or securities in the REIT, or (b) in a public offering of debt obligations of the REIT that have maturities of at least five years. Management must closely monitor cash on hand from new capital to ensure that it appropriately invests this new capital within a one-year period.

Before Breaking Ground

Given the complexities involved in REIT development activities and financing described above, REIT management should be mindful of consulting with its legal counsel and accountants as part of development planning. With proper planning and structuring, development activities can be a successful piece of a REIT's investment platform.

(Footnotes)

1. Real Estate Portfolio, July/Aug. 2006, *Breaking Ground*, p. 42.
2. See, e.g., Priv. Ltr. Ruls. 200410010 (Dec. 2, 2003), 9730010 (Apr. 21, 1997) and 9651033 (Sept. 20, 1996).
3. See Priv. Ltr. Rul. 9651033 (Sept. 20, 1996).
4. See Priv. Ltr. Rul. 9850009 (Sept. 9, 1998).
5. As defined in IRC § 856(d)(3).
6. IRC § 857(a).
7. IRC § 856(c)(5)(D)(ii).

Richard "Chip" Cunningham, Jr., Esq. is an associate and J.M. Ramey, III, Esq. is a shareholder at Hirschler Fleischer, Richmond, VA.