§ 2.02 Transaction Structures

[1]—Conventional REIT Combinations

The most straightforward and common transaction structure for combining two conventional REITs is a direct statutory merger. In a direct merger between two REITs, the constituent REITs combine by filing articles of merger (sometimes called a certificate of merger) with the appropriate state authority, leaving one constituent REIT as the surviving corporation (the "acquiror").[1] The nonsurviving REIT in a direct merger (the "target") ceases to exist as a separate legal entity, and the surviving REIT succeeds by operation of law to all of the assets, liabilities, rights and obligations of both of the constituent REITS. The target may be viewed as transferring its assets and liabilities to the acquiror in the merger before going out of existence. As a result, depending on the circumstances and specific contractual provisions involved, a merger may give rise to the same third-party consent requirements for certain transfers that would arise in a traditional asset sale and may provide target creditors with the right to accelerate target liabilities pursuant to a change of control or other acceleration provision contained in debt instruments.[2] As part of the merger transaction, the shareholders of the target receive shares of the acquiror, cash or some other form of consideration (or some combination of consideration) in exchange for their shares. Before a merger can be consummated, normally both the board of directors[3] and the shareholders[4] of each constituent REIT must approve the transaction.

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[1] See, e.g.:

Delaware: 8 Del. Code. Ann. § 251.

Maryland: 3 Md. Code Ann. Corps. & Ass'ns § 8-501.1.

[2] Third-party consents and liability accelerations may result from any transaction that results in a change in the ownership or control of a corporation whether or not a merger occurs.

[3] See, e.g.:

Delaware: 8 Del. Code Ann. § 251(b) ("The board . . . shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability").

Maryland: Md. Code Ann. Corps. & Ass'ns § 3-105(b) ("The board . . . shall: (1) adopt a resolution which declares that the proposed transaction is advisable . . .").

[4] In the case of Delaware corporations, normally a merger must be approved by a majority of outstanding shares entitled to vote on the transaction. 8 Del. Ann. Code. § 251(c). In the case of Maryland corporations, normally a merger must be approved by two-thirds of the outstanding shares entitled to vote on the transaction (or less than two-thirds if the corporation's charter so provides, but in any event not less than a majority). Md. Code Ann. Corps. & Ass'ns §§ 2-104(a)(5), 3-105(e). Similarly, in the case of Maryland real estate investment trusts normally a merger must be approved by two thirds of the outstanding shares entitled to vote on the transaction (or less than two thirds if the Maryland real estate investment trust's declaration of trust so provides, but in any event not less than a majority). Md. Code Ann. Corps.

As a business combination method, a merger has several advantages.[5] It allows two or more REITs to combine in one step, leaving no minority stockholders. Additionally, as compared to an asset purchase, the merger form may also reduce or eliminate many transaction costs associated with the actual transfer of assets (e.g., sales and real estate transfer taxes and the cost of preparing documents of transfer and filing them with the appropriate authorities, which may involve multiple jurisdictions, and, in some cases, the cost of purchasing new title insurance policies).

The direct merger form has some disadvantages, however. For one, the direct merger structure may give rise to appraisal rights for both the target's and the acquiror's shareholders.[6] In addition, in a direct merger, all of the target's liabilities, including contingent and

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& Ass'ns §§ 8-202(c), 8-501.1(g). Both Delaware and Maryland law allow short-form mergers between a parent and a subsidiary if the parent owns at lease 90% of the subsidiary prior to the transaction. In a short-form merger, provided statutory conditions are met, no shareholder vote is required. See:

Delaware: 8 Del. Code Ann. § 253.

Maryland: Md. Code Ann. Corps. & Ass'ns § 3-106.

[5] See Bainbridge, *Mergers and Acquisitions* § 4.3 (2003).

[6] Under Delaware law, subject to a market-out exception, generally shareholders of both the target and the acquiror have appraisal rights in the merger context provided that they have not voted in favor of the merger and have held their shares through the effective date of the merger. 8 Del. Code Ann. § 262(a). The Delaware market-out exception provides that as long as the merger consideration is stock of the surviving corporation or stock of another corporation that is either listed on a national securities exchange, quoted on Nasdaq, or has more than 2,000 holders (or cash in lieu of fractional shares), no appraisal rights are available to holders of stock in a corporation that is either listed on a national securities exchange, quoted on Nasdaq, or held by more than 2,000 shareholders of record. 8 Del. Code Ann. § 262(b). While the default rule in Delaware is that shareholders of a corporation that amends its charter or sells all or substantially all of its assets do not have appraisal rights, Delaware corporations may provide for such rights in their charters. 8 Del. Code Ann. § 262(c).

Under Maryland law, subject to a market-out exception, generally shareholders of the target in a merger, asset sale or share exchange transaction, as well as shareholders of a corporation that amends its charter in a way that substantially adversely affects their rights, are entitled to appraisal rights. Md. Code Ann. Corps. & Ass'ns § 3-202(a). Only under limited circumstances are the shareholders of the successor corporation in a merger entitled to appraisal rights. Md. Code Ann. Corps. & Ass'ns § 3-202(c)(2). The Maryland market-out exception generally provides that a shareholder of a corporation that is listed on a national securities exchange, quoted on Nasdaq, or designated for trading on the Nasdaq Small Cap Market is not entitled to appraisal rights. Md. Code Ann. Corps. & Ass'ns § 3-202(c)(1). The market-out exception does not apply to business combination transactions with interested shareholders. Md. Code Ann. Corps. & Ass'ns § 3-202(c).

Additionally, Title 8 of the Maryland Code of Corporations and Associations (under which a specific form of unincorporated trust or association called a "Maryland Real Estate Investment Trust" can be formed) only provides for shareholder appraisal rights in connection with mergers. Md. Code Ann. Corps. & Ass'ns § 8-501.1(k). Therefore, shareholders of a Maryland real estate investment trust orga-

unknown liabilities, are inherited by the acquiror by operation of law. This exposure, however, frequently can be avoided through the use of a triangular merger in which the target merges with a subsidiary of the acquiror, which (assuming corporate and other formalities are observed) allows the target's liabilities to be kept at the subsidiary level as opposed to the acquiror level.[7]

In a triangular merger, the acquiror forms a wholly owned subsidiary (a "merger sub") and the merger sub then engages in a statutory merger with the target. Immediately following the merger, the surviving corporation is a wholly owned subsidiary of the acquiror. Because the constituent companies in a triangular merger are the merger sub and the target, the acquiror's shareholders are not required to approve the transaction In a triangular merger, the acquiror forms a wholly owned subsidiary (a "merger sub") and the merger sub then engages in a statutory merger with the target. Immediately following the merger, the surviving corporation is a wholly owned subsidiary of the acquiror. Because the constituent companies in a triangular merger are the merger sub and the target, the acquiror's shareholders are generally not required to approve the transaction, unless the acquiror is publicly traded and is issuing an amount of stock that requires the approval of its shareholders.[8] Only the merger sub's board and sole shareholder (the acquiror) and the target's board and shareholders must approve the transaction. When circumstances permit, public companies will often choose to use this structure rather than a direct merger between the acquiror and the target in order to avoid the costs, uncertainties and delays associated with a second (e.g., target) shareholder vote. Triangular mergers involving REITs raise special tax considerations that are described in Chapter 6.[9]

If the merger sub is the surviving corporation in a triangular merger, the transaction is known as a forward triangular merger. If the target is the surviving corporation in a triangular merger, the transaction is known as a reverse triangular merger. The decision to employ a forward or reverse triangular merger is frequently influenced by tax

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nized under Title 8 do not appear to be entitled to appraisal rights in the event of a share exchange, a charter amendment or sale of all or substantially all assets of the trust.

[7] See the discussion of triangular mergers later in this Section.

[8] For example, the NYSE Listing Manual, applicable to companies listed on the NYSE, requires shareholder approval prior to the issuance of common stock in connection with a transactions or series of related transactions if the amount of stock to be issued is greater than 20% of the total number of shares or total voting power of the common stock outstanding prior to the issuance of the new common stock. NYSE Listing Manual § 312.03(c).

[9] See Chapter 6 *infra*.

issues and various corporate imperatives, including the reduced likelihood of triggering various third-party consent rights in reverse triangular mergers.[10]

Outside of the REIT context, stock purchases, followed by squeeze out mergers, are another common method for acquiring a target corporation. However, stock purchases are not a practical alternative in transactions in which the target is a REIT.[11]

Although rare in the context of public company acquisitions, an acquiror can also effectively acquire a target's business[12] simply by purchasing all or substantially all of the target's assets using cash, securities, or some other form of consideration or a combination thereof. Such a transaction generally requires approval of only the target's board and shareholders (again, unless the acquiror is publicly traded and is issuing an amount of stock that requires the approval of its shareholders).[13] In the public company context, since the transaction costs associated with asset purchases are generally significantly higher than those associated with statutory mergers, asset purchase transactions are rarely used.[14] This is especially true in the REIT context since transferring legal ownership of real estate (especially encumbered real estate) is

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[10] The tax issues involved are described in Chapter 6 *infra*. Reverse triangular mergers are less likely to violate simple anti-assignment provisions in the target's leases, loan documents and other contracts because the corporate identity and form of the party to the contracts—the target—is preserved; there is no "assignment" in the conventional sense. Of course, sophisticated anti-assignment "change of control" provisions may be triggered by a reverse merger and will need to be studied on a case-by-case basis.

[11] See discussion in § 2.03 *infra*.

[12] Note that following an asset sale, in the absence of further action, the target's corporate form, shareholders and liabilities will remain intact.

[13] Under Delaware law, the sale of all or substantially all of the assets of a Delaware corporation must be approved by the seller's board of directors and a majority of the outstanding shares of the selling corporation entitled to vote on the transaction. 8 Del Code Ann. § 271(a).

Under Maryland law, the sale of all or substantially all of the assets of a Maryland corporation must be approved by the seller's board of directors and two-thirds (or less if the corporation's charter so provides, but not less than a majority) of the outstanding shares of the selling corporation entitled to vote on the transaction. Md. Code Ann. Corps. & Ass'ns § 3-105(b), (d).

[14] In a statutory merger, by operation of law, the separate legal existences of the constituent corporations, except for the surviving corporation, are extinguished, and the surviving corporation takes title to all of the assets of the constituent corporations and assumes all of the liabilities of the constituent corporations. In an asset sale, the transaction costs associated with each of these actions may be significant. See Bainbridge, *Mergers and Acquisitions*, § 4.3 (2003). Examples of such costs include sales and real estate transfer taxes, the cost of preparing documents of transfer and filing them with the appropriate authorities, and the costs of obtaining the third-party consents in connection with the transferred assets and liabilities. This is an especially salient concern for acquirors engaging in business combinations with large public

often expensive and time consuming. Moreover, target directors will often prefer a merger or some other form of transaction that does not require them to adopt a plan of liquidation.[15]

There may, however, be advantages to an asset purchase transaction in the appropriate circumstance. For example, the target may have a contingent liability that is viewed far more conservatively by the acquiror than by the target. In that case, the only viable transaction may be an asset sale in a transaction in which the target retains the liability and either remains in existence until the liability is resolved, at which time it liquidates, or liquidates and establishes an escrow or other arrangement to provide for the liability.

A combination of two traditional REITs (REITS that have not adopted an UPREIT structure) is relatively simple as compared to combinations in which one or both of the parties is an UPREIT.[16]

[2]—UPREIT Combinations

A combination of two UPREITs, like the combination of two conventional REITs, can be accomplished through a merger of the two general partner UPREITs. In the case of UPREIT transactions, however, it is also important to consider whether and how to combine the operating partnerships of the two UPREITs. The simplest structure consists of two direct mergers—one between the two UPREITs and another between the two operating partnerships. It is also possible to combine the UPREITs and the operating partnerships through different mechanisms or to continue both operating partnerships as separate partnerships after the merger of the UPREITs. In addition to the factors that must be considered in structuring REIT-REIT combinations, UPREIT combinations require a careful review of the relevant operating partnership agreements. Critical issues are whether the operating partnership agreements provide the OP unitholders with voting or approval rights with regard to any step in the combination of either the UPREITs or the operating partnerships and the post-combination implications for the redemption and conversion mechanics pursuant to which OP unitholders are entitled to convert their OP units into cash or shares in the general partner REIT and/or to retain equity in the surviving operating partnership.

Acquirors must take the tax implications for the target's OP unitholders into account since OP unitholders frequently have the ability to positively or negatively influence a transaction. It is usually of

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company targets, which are likely to have a higher number of assets located in multiple jurisdictions, meaning the corresponding transaction costs associated with identifying (for the purposes of an asset sales agreement) and/or transferring those assets will also be higher.

[15] See § 6.03[1][e], [3][a].

[16] See discussion in § 2.02[2] *infra*.

critical importance to the OP unitholders that the combination not give rise to, or at least minimize (including via tax protection agreements), taxable income or gain; tax deferral most likely motivated them to take OP units instead of stock in the first place. Additionally, careful attention must be paid to any tax protection agreements that the target has in place since such agreements may influence the form of the transaction and may affect the acquiror's business plan for the target's assets post-acquisition. In transactions that trigger an OP unitholder vote or consent right, the potential adverse tax implications for OP unitholders will take on more importance. The potential conflicts that can arise because of the different tax positions and interests of the OP unitholders and the stockholders of the general partner REIT are discussed in Chapter 5.

Unless otherwise provided in the partnership agreement, business combination transactions between two operating partnerships will generally require some form of OP unitholder approval under the statutes governing their formation. For example, many UPREIT operating partnerships are limited partnerships formed under Delaware law, which provides that unless the limited partnership agreement (the operating partnership agreement) provides otherwise, mergers of limited partnerships must be approved by all general partners (generally only the REIT) and a majority of each class of limited partners (the OP unitholders).[17] A well-drafted OP agreement will contain provisions dealing with the approval, if any, needed for transfers of the general partner's interests, sale of all or substantially all of the OP's assets and other noncustomary transactions, so resort to the default rules of the relevant law should not be the usual route for guidance on these issues. In addition, the availability of appraisal rights often depends on whether the operating partnership agreement or the merger or consolidation agreement provides for such rights.[18]

Two UPREIT operating partnerships can sometimes also be combined by having the interests in one OP acquired by the other OP in exchange for cash and/or units. The viability of such a transaction will generally depend on whether the operating partnership agreement allows the necessary transfers of the general partner's OP units. In the absence of any provision governing the transferability of OP units in the operating partnership agreement, the default rule under Delaware law is that limited partners of limited partnerships can freely assign their economic interests in the limited partnership but not their rights or powers as partners,[19] and assignees can only become partners as provided for in the limited partnership agreement or if all of the partners

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[17] 6 Del. Code. Ann. § 17-211.

[18] See 6 Del. Code. Ann. § 17-212.

consent.[20] In considering how best to combine two operating partnerships, in addition to careful examination of the relevant state law, careful examination of the operating partnership agreements is extremely important, as the provisions of these agreements may deviate significantly from the default rules. In any event, it is not always necessary to merge the operating partnerships and it may be satisfactory simply to have the acquiror become the sole general partner of the target OP and allow the limited partners of the target OP to continue as limited partners of the target OP.

Consideration of the effect of a merger on the general partner status of the REIT general partner of the operating partnership is important in the UPREIT business combination context. Under the Delaware Revised Uniform Limited Partnership Act, the assignment by a general partner of its interest in the limited partnership is listed explicitly as an event of withdrawal, unless the limited partnership agreement provides otherwise,[21] and a merger of a general partner with another entity may be deemed to be an assignment of its general partnership interest under certain circumstances.[22] Here, again, it is extremely important to examine the limited partnership agreements of the operating partnerships carefully since the provisions of these agreements may, and frequently do, deviate significantly from the default rules.

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[19] 6 Del. Code. Ann. § 17-702(a). According to the default rules in Delaware, limited and general partners of a Delaware limited partnership can freely assign the economic component of their limited partnership interest. See 6 Del. Ann. Code. § 17-702(a)(4). However, "[a] partner ceases to be a partner and to have the power to exercise any rights or powers of a partner upon the assignment of all of his partnership interest." 6 Del. Ann. Code. § 17-702(a)(4). Additionally, the assignment by a general partner of its interest in the partnership is an event of withdrawal, and the withdrawal of a general partner may lead to the dissolution of the limited partnership under certain circumstances. 6 Del. Ann. Code. §§ 17-402, 17-702(a), 17-801. These default rules can be altered, however, through contrary provisions in the limited partnership agreement.

[20] 6 Del. Ann. Code. § 17-704(a).

[21] 6 Del. Ann. Code. §§ 17-402, 17-702(a).

[22] See, e.g.:

Third Circuit: In re Asian Yard Partners, 1995 WL 1781675, 6 (Bankr. D. Del. 1995) ("If the sale of stock of the corporate general partner results in a change in control of that corporation, then there has effectively been a transfer of the partner interest . . .").

District of Columbia Circuit: Nicolas M. Salgo Associates v. Continental Illinois Properties, 532 F. Supp. 279 (D.D.C. 1981) (holding that a third party's stock purchase of, followed by a merger with, a General Partner target violated the anti-assignment provisions of the limited partnership agreement and noting that "[s]ince the merger has effectively forced plaintiff to accept a new partner without his consent, it runs counter to [the policy of RUPLA].").

But see:

In light of the current and future tax costs to which OP unitholders are exposed in UPREIT combinations, either because of the structure of the transaction itself or because of the loss of control (actual or perceived) that sometimes results from the combination, many UPREIT combination transactions include the adoption of various tax protections designed to assuage the OP unitholders' concerns.[23]

[3]—Mismatch Combinations—Combining a REIT with an UPREIT or Non-REIT Real Estate Operating Company

Combinations of traditional REITs with UPREITs share many of the complications and issues discussed above with regard to UPREIT-UPREIT combinations because of the presence of the operating partnership.[24] An additional complication can result, however, from a requirement in UPREIT operating partnership agreements that all of the UPREIT's assets be held by the operating partnership. This requirements helps maintain the economic equivalence of a share of stock with an OP unit. If such a requirement exists, the non-UPREIT party to the combination transaction will need to consider whether and how to transfer its assets down to operating partnership as well as the associated costs. Regardless of whether the combined entity is structured as an UPREIT (with all of its assets in the operating partnership) or a downREIT (with assets held at both the operating partnership and REIT levels), the operating partnership agreement will often need to be amended in order to fit the new circumstances and such amendment may itself trigger OP unitholder voting rights.

Second Circuit: In re Integrated Resources, Inc., Case No. 90-B-10411 (CB) WL 325414 (Bankr. S.D.N.Y. Oct. 22, 1990) (holding that the sale of 100% a corporate general partner's stock to a new parent did not violate the anti-transfer provisions in the partnership agreement).

State Courts:

Delaware: Star Cellular Telephone Company, Inc. v. Baton Rouge GSA, Inc., 19 Del. J. Corp. L. 875 (Del. Ch. 1993). (Holding that the merger of a wholly owned subsidiary general partner into another wholly owned subsidiary of the same parent did not violate the anti-assignment provision in the limited partnership agreement). According to the *Star Cellular* Court, "it may reasonably be concluded that where an antitransfer clause in a contract does not explicitly prohibit a transfer of property rights to a new entity by a merger, and where performance by the original contracting party is not a material condition and the transfer itself creates no unreasonable risks for the other contracting parties, the court should not presume that the parties intended to prohibit the merger." 19 Del. J. Corp. L. at 890, 891.

[23] For a discussion of OP unitholder tax indemnities in the context of combination transactions see § 6.04[3] *infra*.

[24] See § 2.02[2] *supra* for a discussion of UPREIT-UPREIT combinations.

§ 2.03 Unique Structural Considerations in REIT M&A Transactions

[1]—Overview

A REIT is a creature of the federal income tax law and, in general, any domestic corporation, trust, or association that meets the requirements for qualification imposed by the Code can elect to be taxed as a REIT.[1] Included in the tax law's requirements are restrictions that apply to ownership of the REIT's shares.[2] For example, a REIT must not be "closely held" and must have at least 100 shareholders.[3] These and other share ownership restrictions frequently cause complications in business combination transactions involving REITs. This occurs not only because maintaining REIT status throughout any transaction depends on continued compliance with the Code's ownership restriction provisions, but also because, in order to assure compliance with such provisions, a REIT will often include provisions in its charter imposing limitations on share ownership. The ownership limits contained in a REIT's charter are usually "enforced" through an "excess share provision."[4] Any acquisition of REIT shares or other corporate transaction involving a REIT, especially "hostile" acquisitions, must take careful account of the ownership limitations and excess share provisions because, as described below, the consequences of a violation can be significant.[5]

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[1] In general, a corporation, trust, or association may qualify as a REIT if: (1) it is managed by one or more trustees or directors; (2) its beneficial ownership is evidenced by transferable shares or transferable certificates of beneficial interest; (3) it would be taxable as a domestic corporation but for its taxation as a REIT; (4) it is neither a financial institution nor insurance company; (5) it is owned by at least 100 persons; (6) it is not "closely held," i.e., no more than 50% of the value of its stock may be owned by five or fewer "individual" shareholders at any time during the last half of its taxable year; (7) it elects (or continues in effect a preexisting election) to be taxed as a REIT; and (8) it satisfies the detailed asset and income tests contained in Code Section 856(c). See IRC § 856(a); 26 U.S.C. § 856(a). In addition, in order to be taxed as a REIT, an entity must also meet the distribution requirement contained in Section 857(a)(1) of the Code and must not have any undistributed earnings or profits accumulated in years when the entity was not a REIT. See IRC §§ 857(a)(1) and (2); 26 U.S.C. §§ 857(a)(1) and (2).

[2] See, e.g., IRC § 856(a)(5), 26 U.S.C. § 856(a)(5) (requiring that a REIT be owned by at least 100 persons) and IRC § 856(a)(6), 26 U.S.C. § 856(a)(6) (requiring that a REIT not be "closely held," i.e., that no more than 50% of the value of its stock be owned by five or fewer shareholders at any time during the last half of its taxable year).

[3] See § 6.01 *infra*.

[4] See § 7.02 *infra*.

[5] *Id*.

While the ownership limitations and excess share provisions apply with equal force to friendly transactions, potential acquirors contemplating an unsolicited "hostile" bid view these provisions as a significant takeover defense. This is because a hostile acquiror, unlike a welcome suitor, cannot avoid the ownership limitations by negotiating with the target REIT to effect either a merger transaction between the two companies or an amendment to the ownership limitations in the target REIT's charter. Instead, the hostile acquiror must take its offer directly to the REIT's shareholders, which it will commonly do through a public bear hug letter or the commencement of a cash tender or exchange offer. The purchase of shares in a tender offer in an amount exceeding the ownership limit contained in the target REIT's charter, however, will trigger the excess share provision, also contained in the target REIT's charter, effectively preventing the acquiror from acquiring shares in excess of the ownership limit. For this reason the ownership limitations in the target REITs charter must be addressed upfront and the restrictions overcome for such an offer to succeed.

The use and effectiveness of limitations on share ownership coupled with "excess share provisions" to defend against a hostile offer are discussed in Section 7.02.[6] Indeed, given the universal presence of such provisions in REIT charters, they are properly viewed as the most common advance takeover defense utilized by REITs.[7] In addition, it is important that an acquiror determine as early as possible whether (1) the target REIT has any technical violation of the REIT qualification requirements so that the impact and tax cost of any such technical noncompliance can be evaluated and (2) the target or the target OP has any indemnity obligations to OP unitholders that will increase the acquiror's cost for the transaction or post-acquisition transactions. The presence of such contingent tax liabilities, if significant, can also impede and complicate a REIT acquisition.[8]

This Chapter describes the potential impact on acquisition transactions of the common ownership limitations found in REIT charters, the workings of a typical excess share provision and some tax-related problems that may arise as an acquisition transaction progresses.

[2]—A REIT Cannot Be Closely Held—The Five/Fifty Rule

Ownership limitations designed to prevent a REIT from being closely held in violation of Code Section 856(a)(6) are typically

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[6] *Id.*

[7] *Id.*

[8] For examples of transactions that were complicated when the discovery of inadvertent technical violations of the Code's REIT qualification requirements uncovered unexpected tax liabilities, see § 2.10 *infra*.

adopted as part of a REIT's articles of incorporation and usually restrict the number/value of shares that any shareholder can own to 9.9% or some lesser percentage.[9] The ostensible purpose of such provisions is to ensure compliance with the so-called "five/fifty rule" of the Code, which prohibits five or fewer individuals from owning in the aggregate in excess of 50% of the value of the shares of a REIT during the last half of the REIT's taxable year.[10] In the case of REITs in which a founding individual owns (or upon the exchange of OP units for stock of the REIT would own) more than 10% of the stock, the ownership limit for other shareholders is typically set at a lower percentage, so as to ensure compliance with the five/fifty rule even after taking into account the founder's interest.[11] Under a typical provision, any purported transfer of shares that, if effective, would result in ownership of the REIT's shares in excess of the 9.9% or lower ownership limit is void *ab initio* and the subject shares become "excess shares" that are transferred to a trust for the benefit of a charity.[12] As a result, the purported acquiror obtains no voting rights, has no right to receive dividends on the excess shares and does not benefit economically from an appreciation in the shares' value, but bears the risk of diminution in the shares' value.[13]

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[9] See Lowy, "Real Estate Investment Trusts," in *REITS*: *1999 Strategies for Financing and Growth in a Challenging Market,* No. B0-00HQ pp.87, 102-103 (1137 PLI/Corp. Law and Practice Sept.-Oct. 1999) ("As a result of the 5/50 rule, the articles of many REITs prohibit any shareholder from owning more than 10% (or more often, in order to provide a margin for error, 9.8%) of the shares.").

[10] The "five/fifty rule" is one of the REIT qualification requirements of Section 856(a) of the Code. See IRC § 856(a)(6) and (h)(1)(A); 26 U.S.C. § 856(a)(6) and (h)(1)(A) (excluding from the definition of REIT entities which are closely held pursuant to the stock ownership provisions of Code Section 542(a)(2)).

[11] See Lowy, N. 9 *supra*, at p.103 ("In some REIT's that are created by converting existing partnerships or corporations which have owners that own significant percentages of the outstanding interests, the ownership limitation for other shareholders may be as low as 2%.").

[12] For a more detailed discussion, see § 7.02 *infra*.

[13] The consequences that usually flow from the conversion of shares to excess shares are described in § 7.02 *infra*. As described more fully there, the trustee of the excess shares trust is usually required to sell the excess shares and distribute to the purported acquiror the lesser of the net sale proceeds or the purported acquiror's cost for the shares. Dividends and any increases in value are paid to the trust's designated charity. Through this mechanism, the purported acquiror receives no economic or voting benefit from its purchase. See generally: Priv. Ltr. Rul. 9627017 (Apr. 5, 1996) (discussing the workings and tax implications of excess shares trusts); Priv. Ltr. Rul. 9621032 (Feb. 26, 1996) (same); Priv. Ltr. Rul. 9534022 (May 31, 1995) (same). See also, Fass, *Real Estate Investment Trusts Handbook* § 4:8 (2004) (discussing other issues raised by excess shares trusts).

Importantly, as a pure tax matter, the five/fifty rule operates on a "look through" basis, so that only individuals[14]—not corporations, partnerships or other entities—are restricted in their ownership of a REIT's shares.[15] The tax rule "looks through" entities and focuses instead on the individuals who own the entities and, subject to detailed rules, treats such individuals as owning the REIT stock owned by the entity.[16]

The key to the effectiveness of the excess share provisions as a takeover defense is that they typically do not incorporate the "look through" mechanism of the five/fifty rule. Instead, the provisions are usually worded so as to restrict any entity from acquiring in excess of the stated maximum percentage of shares. Thus, the typical excess share provision would thwart a hostile acquisition of a REIT because a publicly owned acquiror, even though not an individual, would be prevented from acquiring more than the maximum stated number of shares, regardless of whether, under the tax laws, such an acquisition would threaten the target's REIT status because of the Code's look through provisions.[17]

Recognizing the broad applicability of "excess share" provisions, a REIT's charter provisions typically grant the REIT's board of directors the discretion to waive the limitation with respect to particular

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[14] For purposes of the five/fifty rule, certain organizations, in addition to natural persons, are considered "individuals." See IRC §§ 542(a)(2) and 856(h)(1)(A); 26 U.S.C. §§ 542(a)(2) and 856(h)(1)(A).

[15] The "look-through" mechanism is incorporated into the five/fifty rule through the application of Section 544(a)(1) of the Code, which provides that "[s]tock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries." IRC § 544(a)(1); 26 U.S.C. § 544(a)(1).

[16] In addition to the "look-through" mechanism, the five/fifty rule generally applies the attribution rules of Code Section 544 in determining whether an individual will be considered as constructively owning stock that the individual does not actually own; however, the five/fifty rule modifies the provisions of Code Section 544 to waive partner attribution. See IRC § 856(h)(1)(B); 26 U.S.C. § 856(h)(1)(B). Accordingly, an individual is treated as owning any stock that is owned by his brothers and sisters (whether by whole or half blood), spouse, ancestors and lineal descendants, and any person that has an option to acquire stock will be treated as if he owns such stock (convertible securities, whether or not convertible during the taxable year, may also be considered as outstanding stock). See IRC § 544(a)(2), (3), and (b); 26 U.S.C. § 544(a)(2), (3), and (b).

[17] Indeed, some REITs' ownership restrictions go farther still by applying their ownership limits to "groups" as defined under Section 13(d)(3) of the Securities Exchange Act of 1934. See 15 U.S.C. § 78m(d)(3). Section 13(d)(3) of the Act defines a "group" as "two or more persons act[ing] as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer." *Id.*

acquirors if the board is satisfied (through an opinion of counsel or a ruling from the Internal Revenue Service, for example) that the acquiror is not an individual for purposes of Code Section 542(a)(2) (i.e., that the acquiror is a corporation, partnership, estate, trust or any other non-"individual" as to whom the five/fifty rule's look through would apply) and the board obtains such representations and undertakings from the acquiror as it deems reasonably necessary to ascertain that no individual's beneficial ownership of stock through the acquiror will violate the ownership limit. Frequently, the board's discretion is limited so that it cannot waive the ownership limitation to permit ownership in excess of a stated maximum amount (e.g., 10-15%);[18] and as a result, a hostile acquiror is unable to pressure the board into waiving the restriction and permitting the acquiror to acquire enough shares to gain control of the REIT.

In light of the anti-takeover effect of excess share provisions, a hostile acquiror that commences a tender or exchange offer will typically seek to have the provision waived, set aside or nullified as a condition to its offer.[19] The viability and effectiveness of ownership limitations and excess share provisions as a takeover defense and how they compare to shareholder rights plans (A/K/A "poison pills" or simply as "pills") in the context of hostile REIT transactions is examined in Section 7.04.[20] The answer, in short, is that unlike poison pills, excess share ownership limitations are largely untested as takeover defenses, and may not prove to be as effective as pills.[21]

[3]—Beneficial Ownership

Ownership limitations designed to prevent a REIT from violating the five/fifty rule are usually drafted by prohibiting "Beneficial Ownership" of shares in excess of the specified percentage. A defined term like Beneficial Ownership is generally used since the five/fifty rule is applied not only by counting shares directly owned by an individual, but also by treating an individual as owning shares "owned" (including in certain cases shares treated as owned under the tax rules) by the individual's family[22] and by certain entities in which the individual has

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[18] See Appendix D *infra*, Sample Charter with Excess Share Provision, Article VI, Section 4.

[19] See § 6.02 (M&A Tax Considerations) notes 49-51[will probably change when the editor reformats the footnotes] and accompanying text.

[20] See § 7.04 *infra*.

[21] See § 7.04[2] *infra*.

[22] For this purpose, the term "family" means an individual's brothers and sisters (whether by whole or half blood), spouse, ancestors and lineal descendants. IRC § 544(a)(2); 26 U.S.C. § 544(a)(2).

a direct or indirect interest. The tax rules concerning such "beneficial ownership" are very complex and very broad, and so those rules are usually incorporated into the defined term by reference to the applicable Code Section. Readers of REIT charters are accustomed to seeing the term Beneficial Ownership of a REIT's shares defined as including shares owned directly and shares owned as a result of Code Section 544, as modified by Code Section 856(h)(1)(B).[23] In some cases, a REIT's charter may define Beneficial Ownership more broadly than the Code requirements by including provisions that result in a person owning shares owned by members of a so-called 13(d) group.

[4]—A REIT Must Be Owned by 100 or More Persons

Not only will an entity fail to qualify as a REIT for federal income tax purposes if its shares are "closely held" in violation of the five/fifty rule described above,[24] it will also fail to qualify as a REIT if its shares are owned by fewer than 100 persons.[25] A person[26] seeking to acquire a significant or controlling block of REIT shares must also consider charter provisions the REIT has adopted to prevent share accumulations that could result in its shares becoming held by fewer than 100 shareholders.[27]

In contrast to the five/fifty rule, the 100 shareholder requirement is not a significant impediment to share accumulations primarily for two reasons. First, a REIT need only pass the 100 shareholder test during 335 days out of a twelve-month tax year.[28] Second, every shareholder,

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[23] See Appendix D *infra*, Sample Charter with Excess Share Provision, Article VI, Section 1.

[24] See § 2.03[2] *supra*.

[25] See IRC § 856(a)(5); 26 U.S.C. § 856(a)(5).

[26] As used herein, unless otherwise noted, the term "person" means a person as defined in Code Section 7701(a)(1), which includes "an individual, a trust, estate, partnership, association, company or corporation." IRC § 7701(a)(1); 26 U.S.C. § 7701(a)(1).

[27] Treasury Regulation Section 1.856-1(d)(2) states that charter or bylaw provisions that permit the directors to refuse to transfer shares if the directors believe in good faith that the transfer would cause the loss of REIT status do not render the REIT's shares nontransferable in violation of Section 856(a)(2) of the Code. See Treas. Reg. § 1.856-1(d)(2); 26 C.F.R. § 1.856-1(d)(2). See also, IRC § 856(a)(2); 26 U.S.C. § 856(a)(2). This Regulation has been applied to typical excess share provisions in a number of private letter rulings. See, e.g.: Priv. Ltr. Rul. 200052037 (Oct. 2, 2000); Priv. Ltr. Rul. 9627017 (Apr. 5, 1996); Priv. Ltr. Rul. 9621032 (Feb. 26, 1996); Priv. Ltr. Rul. 9552047 (Sept. 29, 1995); Priv. Ltr. Rul. 9534022 (May. 31, 1995). The issue of whether the use of very expensive ownership limitations can cause a REIT's shares to be considered nontransferable in violation of Section 856(a)(2) of the Code is considered in § 2.03[7] *infra*.

[28] See IRC § 856(b); 26 U.S.C. § 856(b).

including a shareholder who owns only a small amount of nonvoting stock, counts toward the 100 shareholder minimum.[29] An acquiror of a REIT, therefore, typically has a period of time in which it can place a small number of shares with third parties (often employees of the acquiror or charities) and thereby satisfy the 100 shareholder requirement. Additionally, careful planning can generally solve problems raised by charter provisions preventing accumulations that would result in the REIT not satisfying the 100 shareholders requirement. It remains important, however, that the existence of such a charter provision not be overlooked.

[5]—Charter Restrictions that Preserve a REIT's Status as a "Domestically Controlled REIT"

Another form of ownership restriction sometimes found in REIT charters prohibits ownership transfers that would cause the REIT to fail to qualify as a "domestically controlled REIT" within the meaning of Code Section 897(h)(4)(B).[30] "Domestically controlled" status carries particular significance for non-U.S. shareholders because it exempts gains on sales of such a REIT's shares from the rigors of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[31] A REIT is domestically controlled if, at all times during the preceding five years, less than 50% of the value of its stock was held "directly or indirectly" by foreign persons.[32]

FIRPTA treats the gain or loss of a nonresident alien or a foreign corporation from the disposition of a "United States real property interest" (USRPI) as effectively connected to a U.S. trade or business,[33] and hence subject to U.S. income tax.[34] In addition, transfer*ees* who acquire USRPIs from a foreign person are generally required to collect a FIRPTA withholding tax of up to 10% of the *amount realized* on the sale.[35]

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[29] See, e.g., Priv. Ltr. Rul. 8342016 (July 13, 1983). The Internal Revenue Service, pending further study, is apparently no longer issuing rulings that a shareholder whose ownership interest in the REIT is nominal counts as a shareholder for the 100 shareholder requirement. The 100 shareholder requirement, nevertheless, is not difficult to satisfy, and there is no support in the Code or the Regulations for ignoring nominal unrestricted share ownership by a *bona fide* shareholder.

[30] See IRC § 897(h)(4)(B); 26 U.S.C. § 897(h)(4)(B).

[31] Pub. L. No. 96-499, 94 Stat. 2599 (1980). See also, IRC § 1445; 26 USC § 1445.

[32] See IRC § 897(h)(4)(B); 26 U.S.C. § 897(h)(4)(B).

[33] See IRC § 897(a); 26 U.S.C. § 897(a).

[34] See: IRC § 871(b); 26 U.S.C. § 871(b) (imposing U.S. income tax liability on nonresident aliens for "effectively connected" income) and IRC § 882(a); 26 U.S.C. § 882(a) (same for foreign corporations).

[35] See IRC § 1445(a); 26 U.S.C. § 1445(a). Any tax withheld under Section

Because USRPIs include interests in corporations 50% of whose assets by fair market value consist of USRPIs (U.S. real property holding corporations or USRPHCs),[36] REIT shares would potentially lie within FIRPTA's scope. The Act, however, expressly excepts domestically controlled REITs from its coverage.[37] Sales of stock of a domestically controlled REIT by a foreign person are therefore not subject to U.S. income tax or FIRPTA withholding.[38] As a result, foreign investors who seek to invest in U.S. real estate[39] gain important tax advantages by indirectly investing in such real estate through domestically controlled REITs. Because of their different focus, charter provisions designed to preserve a REIT's domestically controlled status can apply and void a share acquisition that does not otherwise exceed the REIT's general ownership limitations.

Given the importance of domestically controlled status to foreign investors who contemplate making significant investments in REITs, it is often necessary to determine the percentage of a REIT's stock

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1445(a) of the Code is credited against the amount of income tax due from the foreign transferor. See Treas. Reg. § 1.1445-1(f)(1); 26 C.F.R. § 1.1445-1(f)(1). Note that there is generally no withholding obligation on the acquisition of stock of a domestic corporation that is regularly traded on an established securities market. IRC §1445(b)(6), 26 U.S.C. § 1445(b)(6); Treas. Reg. § 1.1445-2(c)(2), 26 C.F.R. § 1.1445-2(c)(2).

[36] See IRC § 897(c)(1)(A)(ii) and (c)(2); 26 U.S.C. § 897(c)(1)(A)(ii) and (c)(2).

[37] See IRC § 897(h)(2); 26 U.S.C. § 897(h)(2). There are two other important exceptions. Stock of a REIT that is regularly traded on an established securities market is only treated as a USRPI in the hands of an investor that held more than 5% of such class of stock at some time during the preceding five-year period. See IRC § 897(c)(3); 26 U.S.C. § 897(c)(3). In addition, since a USRPI does not include an interest solely as a creditor, a so-called mortgage REIT may not be a USRPHC. See IRC § 897(c)(1)(A)(ii) and (i)(3); 26 U.S.C. § 897(c)(A)(ii) and (i)(3). See generally, IRC § 897(c); 26 U.S.C. § 897(c). Accordingly, interests in a mortgage REIT may also escape USRPI status.

[38] See: IRC §§ 897(h)(2) and 1445(a); 26 U.S.C. §§ 897(h)(2) and 1445(a). See also, Treas. Reg. §§ 1.1445-2(c)(1), 1.897-1(c)(2)(i); 26 C.F.R. §§ 1.1445-2(c)(1), 1.897-1(c)(2)(i).

[39] A not insignificant investment clientele: "Approximately 5 to 10 percent of the common shares of the largest institutionally favored U.S. REITs are held by foreign investors . . . ." Parsons, "REITs and Institutional Investors," in *Real Estate Investment Trusts* 413, 422 (Garrigan and Parsons eds. 1998). Moreover, changes in the law may increase foreign ownership of REITs by eliminating some of the circumstances in which foreigners may be subject to federal income tax under the FIRPTA rules. As a result of the American Jobs Creation Act, Pub. L. No. 108-357,118 Stat. 1418 (2004), generally distributions to a foreign REIT shareholder that are attributable to gains by a REIT on its sale of U.S. real property will no longer be subject to FIRPTA if the distribution is made on the REIT's class of stock that is publicly traded and the recipient foreign shareholder owns 5% or less of that class of stock. See IRC § 897(h)(1); 26 U.S.C. § 897(h)(1). See also, Edwards and Bernstein, "REITs Improved," 21 Tax Manag. Real Estate J. 31 (Feb. 2, 2005).

owned by foreign persons.[40] However, even when the facts are known, interpretive issues arise over whether particular shares are or were "held directly or indirectly" by a foreign person.[41] The following example illustrates the problem of indirect holdings:

Example

Assume that a real estate investment trust organized in Maryland (U.S. REIT) has a charter provision that voids transfers to the extent that such transfers would cause the REIT to lose its status as a domestically controlled REIT. Assume that widely held foreign corporation (FC) directly owns 44% by value of U.S. REIT and that a Delaware corporation (DC) that is wholly owned by foreign individual A (FI-A) has as its sole asset 5% by value of the stock of U.S. REIT. Foreign individual B (FI-B) wishes to acquire 5% by value of the stock of U.S. REIT. Assuming that no other foreign person owns a direct or indirect interest in U.S. REIT, will the acquisition by FI-B cause U.S. REIT to cease being domestically controlled and will U.S. REIT's charter cause all or part of FI-B's purported acquisition of U.S. REIT shares to be void?

The answers depend on whether FI-A holds "indirectly" the U.S. REIT shares that are directly owned by FI-A's wholly owned corporation (DC). Unfortunately, the Code does not define when stock is held indirectly by a foreign person for purposes of determining whether a REIT is domestically controlled,[42] and the tax law in general provides no clear answer as to when stock is treated as being held or owned "indirectly."[43] What then is the meaning of stock held indirectly for purposes of Section 897(h)?

The Regulations under Section 897 simply repeat the Code's definition of "domestically controlled" without defining "indirect ownership,"

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[40] Indeed, under certain circumstances, a domestic corporation must, upon request from a foreign person owning an interest in it, inform such owner whether the interest constitutes a USRPI. See Treas. Reg. § 1.897-2(h); 26 C.F.R. § 1.897-2(h).

[41] Code Section 897(h)(4)(B) refers to shares that are directly and indirectly "held" and not to shares that are directly and indirectly "owned." In this instance, the difference does not appear to be substantive. See IRC § 897(h)(4)(B); 26 U.S.C. § 897(h)(4)(B).

[42] See *id*. Since the attribution rules of Code Section 318 are not expressly made applicable to the determination of whether a REIT is domestically controlled, they do not apply. See IRC § 318(a); 26 U.S.C. § 318(a).

[43] See Jackel and Dance, "Indirect Ownership Through a Partnership: What Does It Mean?," 96 Tax Notes Today 3-37 (1996) (discussing rulings in which the Service has found indirect ownership by attribution despite the lack of any expressly applicable constructive ownership provision of the Code).

but the Regulations add the following: "[f]or purposes of this determination the actual owners of stock, as determined under § 1.857-8, must be taken into account."[44] Treasury Regulation Section 1.857-8(b) provides that the "actual owner of stock of a real estate investment trust is the person who is required to include in gross income in his return the dividend received on the stock."[45] Accordingly, the reference to Treasury Regulation Section 1.857-8 is highly suggestive that for purposes of Section 897(h), indirect holders are those holders who would be considered "actual owners" under Treasury Regulation Section 1.857-8.[46]

Pursuant to Treasury Regulation Section 1.857-8, DC in our example is the actual owner of U.S. REIT stock. The conclusion that DC is the actual owner of the U.S. REIT stock does not necessarily mean that FI-A does not hold indirectly through DC the U.S. REIT stock which is actually owned by DC. The fact that the Code generally resorts to specific constructive ownership rules to attribute a corporate entity's ownership to its shareholders, however, supports the view that indirect ownership does not generally look through corporations,[47] although the meaning under general tax rules of the term "indirect," as applied to ownership, is unclear.[48] While there would seem to be no clear policy reason to treat a foreign person as holding indirectly interests in a REIT owned by a domestic corporation that is fully subject to U.S. taxation, the language of Code Section 897 is not as clear as it could be in this regard. Indeed, the policy behind the decision to treat domestically controlled REITs differently at all is obscure.[49]

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[44] Treas. Reg. § 1.897-1(c)(2)(i); 26 C.F.R. § 1.897-1(c)(2)(i).

[45] Treas. Reg. § 1.857-8(b); 26 C.F.R. § 1.857-8(b).

[46] See Treas. Reg. § 1.857-8; 26 C.F.R. § 1.857-8.

[47] Professors Bittker and Eustice, in commenting on the terminology on "actual," "direct," and "indirect" ownership in the context of Section 318 of the Code, explain:

> "'Actual stock ownership' is referred to in various provisions of §318 as stock owned 'directly or indirectly,' i.e., stock titled in the name of the owner (direct ownership) or held by an agent (indirect ownership). 'Indirect ownership,' therefore, does not mean ownership by attribution . . . otherwise, reattribution would occur by virtue of this phrase in all cases and not by virtue of §318(a)(5), which provides reattribution in most, but not all, cases."

Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 9.02[1] at 9-13 & n.41 (7th ed. 2002).

[48] See Jackel and Dance, N. 43 *supra*, at 95-96.

[49] While it may be possible for direct and indirect foreign holders to cause the REIT to elect or to forgo an election under Code Section 857(b)(3)(C) to treat part of a distribution as capital gain, the ability to control the election concerning the character of the distribution is not likely to be of significant benefit to foreign shareholders under FIRPTA. See IRC § 857(b)(3)(C); 26 U.S.C. § 857(b)(3)(C). Code Section 897(h)(1) treats distributions to a REIT's foreign shareholders as gain recognized by

Going back to the example, FI-B should be able to purchase 5% of U.S. REIT stock without causing U.S. REIT to lose its status as a domestically controlled REIT.[50] Admittedly, however, faith in this conclusion likely has more to do with the lack of any clear policy reason to find otherwise than with the strength of the textual analysis.[51] Ideally, the Service should clarify the meaning of "indirectly" as used

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the shareholder on the sale or exchange of a USRPI to the extent the distribution is attributable to the REIT's gain on sales or exchanges of USRPIs, apparently without regard as to whether the REIT elects to treat the distribution as capital gain dividend. See IRC § 897(h)(1); 26 U.S.C. § 897(h)(1). Moreover, as a result of the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34, 111 Stat 788), a REIT may retain capital gain proceeds but must pay a REIT-level tax and pass through a tax credit to its shareholders under Section 857(b)(3)(D). See IRC § 857(b)(3)(D); 26 U.S.C. § 857(b)(3)(D). Thus, it does not appear that foreign persons can dispose of USRPIs through a nondomestically controlled REIT without incurring U.S. income tax liability either directly, upon receipt of distributions attributable to gain on dispositions of USRPIs, or indirectly, by way of a REIT-level capital gains tax.

The legislative history of FIRPTA provides little guidance on this issue. In what may be a clue, the U.S. House of Representatives reported its concerns that under prior law a foreign investor actually engaged in a U.S. real estate business could avoid U.S. capital gains taxes by selling property on an installment basis so as to receive income in a later year in which the gain would not be effectively connected with a U.S. trade or business, or through like-kind exchanges of U.S. real property for foreign real property. See H.R. Rep. No. 96-1167, 96th Cong., 2d Sess. at 509-510 (1980). Although the only House or Senate report that expressly mentions the domestically control REIT exception does not comment on its rationale, it might be speculated that Congress believed these types of manipulations to be less likely in the case of domestically controlled REITs. See H.R. Conf. Rep. No. 96-1479, 96th Cong., 2d Sess. (1980).

[50] Although the answer should be the same, a "harder" case would involve a foreign 49% owner of a REIT that creates a wholly owned domestic subsidiary exclusively to hold an additional 2% interest in that REIT.

[51] Lesser problems with the meaning of direct and indirect ownership arise under Code Section 856(d) in connection with the calculation of "rents from real property." See IRC § 856(d); 26 U.S.C. § 856(d). The term "rents from real property" does not include amounts received by the REIT from any person if the REIT owns, "directly or indirectly," 10% or more of the total combined voting power or of the total value of all shares of all classes of such person. See IRC § 856(d)(2)(B)(i); 26 U.S.C. § 856(d)(2)(B)(i). For this purpose, the constructive ownership rules of Code Section 318 are expressly made applicable, with certain modifications, to determinations of share ownership. See IRC § 856(d)(5); 26 U.S.C. § 856(d)(5). See also, IRC § 318; 26 U.S.C. § 318. Although the use of language calling for both constructive ownership and indirect ownership suggests that the terms are not coextensive, the Regulations under Section 856(d) strongly suggest otherwise. Indeed, Treasury Regulation Section 1.856-4(b)(7) provides that for purposes of Section 856(d)(2) (relating to rents received from related tenants) and Section 856(d)(3) (relating to the determination of whether a person is an independent contractor) "direct or indirect" ownership is determined using the rules of Section 318. See Treas. Reg. § 1.856-4(b)(7); 26 C.F.R. § 1.856-4(b)(7). No similar provision is contained in the Regulations under Section 897.

in Section 897(h) as well as in other sections, because the concept of indirect ownership permeates the Code and Regulations and lacks any consistent, clearly articulated meaning.[52]

[6]—Charter Restrictions that Prevent Related Tenant Rent Income

A REIT's charter may also contain provisions that limit an acquiror's ability to acquire the REIT's shares if the acquisition would result in "related tenant rent."[53] Qualification as a REIT requires ongoing compliance with certain income and assets tests.[54] The applicable income tests require, among other matters, a REIT's income to consist almost entirely of real estate related items of income, such as "rents from real property" as defined in Code Section 856(d), and other forms of passive income.[55] Not all rental income qualifies as rents from real property. Code Section 856(d)(2)(B) provides generally that rents from real property do not include any amount received directly or indirectly from certain related tenants—roughly speaking, tenants 10% or more of whose vote or value is actually or constructively owned by the REIT.[56] However, the

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[52] Code Section 269 uses the term "indirectly" in a manner similar to that of Section 897(h), but Section 269 serves a very special purpose. *Compare*, IRC § 897(h), 26 U.S.C. § 897(h) *with* IRC § 269, 26 U.S.C. § 897(h). Section 269 generally allows the Service to disallow, *inter alia*, net operating loss carryovers if a person acquires "directly or indirectly" control of a corporation for the purpose of avoiding tax, where control is defined as the ownership of stock possessing at least 50% of the voting power or value of all classes of stock. See IRC § 269(a); 26 U.S.C. § 269(a). The fact that in Section 269(a) the term "indirectly" modifies "acquires," a verb, should not make a substantive difference. In 1980, the Service ruled that the attribution rules of Code Section 318 did not apply to Section 269, but indicated, without citation of authority, that a corporation that owned 45% of a holding company indirectly owned 45% of each of the holding company's subsidiaries. See Rev. Rul. 80-46, 1980-1 C.B. 62. Based on Revenue Ruling 80-46, the Service, at least for purposes of Section 269, views the acquisition of the stock of a parent company as an indirect acquisition of the stock of its direct subsidiaries. See Rev. Rul. 80-64.

[53] See IRC § 856(d)(2)(B); 26 U.S.C. § 856(d)(2)(B).

[54] See IRC § 856(c); 26 U.S.C. § 856(c). See discussion in § 6.01 *infra*.

[55] *Id*.

[56] A tenant is related to the REIT if the REIT owns, directly or indirectly, either (1) stock of such tenant possessing 10% or more of the total combined voting power of all classes of stock entitled to vote, (2) 10% or more of the total value of shares of all classes of stock of such tenant, or (3) if the tenant is not a corporation, an interest of 10% or more in the assets or net profits of such tenant. See IRC § 856(d)(2)(B); 26 U.S.C. § 856(d)(2)(B). Because the determination of the amount of stock owned by the REIT takes into account the constructive ownership rules of Code Section 318, the REIT is treated as owning (among other shares) the stock owned by an owner of 10% or more of the REIT's stock. See IRC §§ 318(a) and 856(d)(5); 26 U.S.C. §§ 318(a) and 856(d)(5).

1999 Tax Relief Act[57] amended Code Section 856(d)(2)(B) by adding an exception that permits a REIT to include as "rents from real property" any rental income received from a related "taxable REIT subsidiary"[58] that meets specified requirements.[59]

Unwittingly receiving related tenant income is a distinct possibility, for in determining the ownership of stock, assets or net profits of a tenant, the constructive ownership rules of Code Section 318 apply with greatly expanded reach.[60] Code Section 856(d)(5) replaces Section 318's 50% ownership threshold for attribution to and from corporations with a much lower 10% trigger.[61] Moreover, the Regulations under Section 856 indicate that related tenant income includes rents received indirectly from subtenants, thus further complicating the task of monitoring compliance with the rule.[62]

While the Code is silent as to whether the necessary ownership must be present at the time the rent is accrued or at the time the rent is received, the Regulations provide that rent from real property "does not include any amounts received or accrued, directly or indirectly, from any person in which the real estate investment trust owns, *at any time during the taxable year*, the specified percentage or number of shares of stock (or interest in the assets or net profits) of that person."[63] Read literally, even if the relationship is established on the first day of the twelfth month of a REIT's tax year, the rent received by the REIT during the prior eleven months of the year and before

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[57] Pub. L. No. 106-170, 113 Stat. 1860 (1999).

[58] The term "taxable REIT subsidiary" (TRS) is defined in Code Section 856(l). See IRC § 856(l); 26 U.S.C. § 856(l). A TRS is a corporate subsidiary of a REIT that is permitted to engage in activities in which the REIT cannot, and which is taxed at regular corporate rates.

[59] See IRC §§ 856(d)(2)(B) and (d)(8); 26 U.S.C. §§ 856(d)(2)(B) and (d)(8).

[60] The constructive ownership rules contained in Section 318 of the Code are broader than those employed by Code Section 544 (the rules used with respect to the five/fifty rule). The rules in Code Section 318 operate in a manner that not only treats certain owners of an entity as owning stock owned (and in certain cases constructively owned) by the entity but also, unlike the rules contained in Section 544, treats an entity as owning stock owned (and in some cases constructively owned) by the entity's owners. See: IRC §§ 318 and 544; 26 U.S.C. §§ 318 and 544.

[61] See IRC § 856(d)(5); 26 U.S.C. § 856(d)(5). Because the constructive ownership rules of Code Section 318 are quite different from those of Section 544 that apply for purposes of the five/fifty rule, an acquiror may accumulate the requisite 10% ownership for purposes of the related tenant rules without exceeding a numerically smaller general share ownership limitation that uses Section 544's constructive ownership rules. *Compare*, IRC § 318(a)(3), 26 U.S.C. § 318(a)(3) *with* IRC § 544, 26 U.S.C. § 544.

[62] See, e.g., Treas. Reg. § 1.856-4(b)(4); 26 C.F.R. § 1.856-4(b)(4).

[63] *Id*. (Emphasis added.)

the relationship existed is "bad." This appears to be so even if the related person is no longer a tenant on the date on which the REIT acquires the specified interest in that person.[64] Despite the absence of a clear policy rationale for such a literal interpretation,[65] the Regulations' onerous reporting requirements appear to support it. Treasury Regulation Section 1.856-4(b)(4) mandates that a REIT that receives "directly or indirectly, any amount of rent from any person in which it owns any proprietary interest" shall file with its return for the taxable year a schedule setting forth the name and address of any such person, the amount of rent received, and the highest percentage interest in the person owned by the REIT at any time during the taxable year.[66] No request is made for the dates on which the person was a tenant of the REIT or the date on which the REIT owned its highest percentage interest. The Regulation thus appears to be a case of overly broad drafting. Given that the nature of a REIT's income is a qualification issue on which the REIT would have the burden of proof in a dispute with the Service, the Treasury should reevaluate the related tenant income Regulation with due consideration to the policy to be served and the difficulty of self-monitoring compliance.

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[64] For example, suppose A owns a 10% interest in REIT tenant B Corp. but owns no interest in the REIT from January through November. On November 30, the B Corp.'s lease with the REIT terminates and is not renewed. On December 1, A, still owning 10% of B Corp., acquires a 10% interest in the REIT. Because by attribution the REIT owns the specified percentage of B Corp. in December, a literal reading of Treasury Regulation Section 1.856-4(b)(4) could result in disqualification of all rent received by the REIT from B Corp. for the year, *even though B Corp. is no longer a tenant of the REIT in December.*

[65] What policy is the Regulation protecting? The Code may reflect the congressional policy that a REIT can only earn income from defined activities and should not be able to indirectly receive income earned by a 10% owned entity engaged in a business that the REIT could not engage in directly. See H.R. Rep. No. 86-2020, 86th Cong., 2d Sess. at 4 (1960). Alternatively, this rule may be a backstop to the requirement that a REIT be a passive investor and the belief that an ownership of 10% or more of a tenant might make the REIT too active. Similarly, it has been suggested that the asset diversification requirement contained in Code Section 856(c)(4)(B)(iii) that prohibits a REIT from owning 10% or more of the vote or value of any one corporation "may reflect a policy that a REIT cannot carry on indirectly through an affiliate activities in which it could not engage directly." See Corry, "Stapled Stock—Time for a New Look," 36 Tax L. Rev. 167, 178-179 (1981). However, as noted above, when Congress introduced the TRS in the 1999 Tax Relief Act, it was excepted from the general rule that REITs cannot include income paid by related tenants as "rents from real property." See IRC § 856(d)(2)(B) and (d)(8); 26 U.S.C. § 856(d)(2)(B) and (d)(8). In addition, the TRS was excepted from the rule that prohibited REITs from owning more than 10% of any corporation. See IRC § 856(c)(4)(B)(iii); 26 U.S.C. § 856(c)(4)(B)(iii).

[66] See Treas. Reg. § 1.856-4(b)(4); 26 C.F.R. § 1.856-4(b)(4).

[7]—How Far Can a REIT Go in Limiting Share Ownership?—Transferability Issues

By law, the beneficial ownership of a REIT must be evidenced by transferable shares or transferable certificates of beneficial interest.[67] As noted above, a typical ownership limitation charter provision prohibits transfers of shares that would result in the transferee holding an amount of stock in excess of a specified percentage and a typical excess share provision effectively voids *ab initio* any purported transfer in violation of the specified percentage.[68] How far can a REIT go in using ownership limitations to protect against unsolicited takeovers and share accumulations without creating an unacceptable risk that its shares will be viewed as nontransferable in violation of the REIT qualification rules?

The Code and Regulations provide no explanation for the transferability requirement. Many REIT advisors believe the requirement that a REIT's shares be transferable is a holdover from the time when REITs had to be organized as unincorporated trusts or associations under local law.[69] Nevertheless, the requirement of transferable shares

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[67] See IRC § 856(a)(2); 26 U.S.C. § 856(a)(2).

[68] See § 2.03[2] *supra*.

[69] Prior to the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976), a REIT could not be organized as a corporation.

[70] Because transferability of shares is a condition for qualification as a REIT, REITs frequently seek the protection of a private letter ruling on the issue of whether their share ownership limitations and excess share provisions render their shares nontransferable in violation of Section 856(a)(2) of the Code. Accordingly, a large number of repetitive rulings have been issued on this subject. See, e.g.: Priv. Ltr. Rul. 200052037 (Oct. 2, 2000) (holding that a "reasonable and minor limitation on the potential universe of stock transferees that is intended to preserve certain favorable tax attributes and safeguard [a REIT's status as such]" does not violate Section 856(a)(2)); Priv. Ltr. Rul. 9552047 (Sept. 29, 1995) (holding that "[t]he Ownership Restrictions will not cause Company to fail to satisfy the requirement imposed by Section 856(a)(2) of the Code that beneficial ownership of a REIT must be evidenced by transferable shares").

REITs, in order to receive rulings that ownership limitations and excess share provisions contained in their charter protect them from being closely held, have been representing to the Internal Revenue Service that the charter provisions concerning ownership limits and excess shares are enforceable under applicable state law and that the REIT will enforce the restrictions. See, e.g., Priv. Ltr. Rul. 9621032 (Feb. 26, 1996) ("[A]s long as the restrictions on transfers in excess of the Ownership Limit are valid under the laws of State X and Trust uses its best efforts to enforce the restrictions, a transfer made in violation of the Ownership Limit to a Prohibited Transferee will not result in those shares being owned by the Prohibited Transferee for federal income tax purposes") If the charter provisions are not enforceable, the result could be disqualification. See, e.g., Priv. Ltr. Rul. 9205030 which concluded that [i]f (1) any person attempts to acquire shares in contravention of the restrictions contained in the Articles, (2) those restrictions are set aside by a final court order,

remains and its parameters are not clear. Despite the number of private letter rulings on the subject,[70] little in the way of "authority" or explanation exists as to what this requirement means. Because the transferable shares requirement is a REIT qualification issue, REITs are justifiably cautious.

Treasury Regulations and private letter rulings do at least confirm that transfer and ownership restrictions designed to protect REIT status do not cause the shares to be nontransferable in violation of Code Section 856(a)(2).[71] Although the Service has ruled that certain restrictions on transferability that are not necessary to preserve REIT status do not cause a REIT's shares to be nontransferable, such rulings do not explain the policy behind the transferability rule or contain any standard that can be applied to determine when shares are not transferable.[72]

For instance, in private letter rulings on restricted stock plans, the Service has distinguished between transfer restrictions that apply to shares issued to employees as compensation and those that apply to shares issued to investors.[73] In those rulings, the Service has indicated

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and, (3) the Company meets the stock ownership requirement of section 542(a)(2), then the transfer will be considered effective, and the Company will be closely held within the meaning of 856(a)(6), on and after the date that the court order becomes final." While not entirely free from doubt, excess share provisions that only limit individual ownership to the extent necessary to protect REIT status are generally believed to be enforceable as a matter of corporate law. Charter provisions that impose transfer restrictions beyond those necessary to protect REIT status, however, have not been fully tested in the courts, though there may be some legislative authority for their enforcement under Maryland law. See § 7.03 *infra*.

[71] Treasury Regulation Section 1.856-1(d)(2) provides:

> "Provisions in the trust instrument or corporate charter or by laws which permit the trustee or directors to redeem shares or to refuse to transfer shares in any case where the trustee 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 real estate investment trust will not render the shares 'nontransferable.'"

Treas. Reg. § 1.856-1(d)(2); 26 C.F.R. § 1.856-1(d)(2).

See also: Priv. Ltr. Rul. 200052037 (Oct. 2, 2000) (applying the Regulation); Priv. Ltr. Rul. 9627017 (Apr. 5, 1996) (same); Priv. Ltr. Rul. 9552047 (Sept. 29, 1995) (same); Priv. Ltr. Rul. 9534022 (Aug. 25, 1995) (same).

[72] The Service has ruled that the use of restricted stock as compensation does not cause a REIT's shares to be nontransferable. See: Priv. Ltr. Rul. 9747034 (Aug. 25, 1997); Priv. Ltr. Rul. 9534022 (May 31, 1995); Priv. Ltr. Rul. 9440026 (July 11, 1994). The Service has also ruled that sale restrictions imposed by the securities laws do not cause a REIT's shares to be nontransferable. See Priv. Ltr. Rul. 9630016 (Apr. 26, 1996). In addition, the Service has ruled that restrictions to protect the status of a REIT as "domestically controlled" (within the meaning of Code Section 897(h)(4)(B)) do not cause the REIT's shares to be nontransferable. See *id*.

[73] See, e.g., Priv. Ltr. Rul. 9747034 (Aug. 25, 1997).

that the requirement that REIT shares be transferable was intended to inure to the benefit of small investors.[74] Reasoning that the restrictions on the small percentage of stock issued to employees will not affect the ability of investors to transfer the REIT's shares on the stock exchange, the Service has ruled that transfer restrictions on employee stock do not render a REIT's shares nontransferable.[75]

In another private letter ruling, a REIT had adopted an ownership limit of 3.9%.[76] The letter ruling pointed out that after the adoption of the 3.9% ownership limit, the REIT's shares would continue to trade on the Nasdaq National Market System and that, based on prevailing market prices, 3.9% of the REIT's shares represented an investment of $10 million. As a matter of common sense, shares should be considered transferable if investors have the ability to freely trade REIT shares in blocks of up to $10 million on the Nasdaq.

Nothing in the foregoing private ruling should be read to imply that trading on the Nasdaq may be insufficient to demonstrate that shares are transferable if the ownership limit translates into a dollar amount investment that is less than the $10 million block described in the private ruling. Instead, the private ruling should be read to express the sensible conclusion that the transferability requirement is intended to be for the benefit of small investors and that limited share transfer restrictions on significant blocks of shares are permissible. Nevertheless, the ruling does not resolve this issue.

Viewed from the perspective of the typical small investor for whom REITs were intended to provide real estate investment opportunities, the usual ownership limitations and excess shares provisions do not render shares nontransferable. Rather, such provisions at most may operate to change the intended transferee to the excess shares trust and to limit somewhat the class of potential large transferees. Only in extreme cases could it be argued that such provisions cause shares to be nontransferable. Nevertheless, many important questions remain open. Would a REIT's charter raise transferability issues if it contained ownership limitations that far exceed or were unrelated to those necessary to protect REIT status?[77] Must all of a REIT's shares be transferable or only some percentage? Can a REIT whose shares (or a substantial percentage thereof) trade on a national exchange ever fail the transferability requirement?

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[74] See *id*.
[75] *Id*.
[76] See Priv. Ltr. Rul. 8921067 (Feb. 28, 1989).
[77] For example, "group" level ownership limits. See § 7.03 N. 26 *infra* and accompanying text.

While the answers to some transferable shares questions may appear to be clear (with varying degrees of clarity) to REIT tax advisors, and the limited "authority" suggests that the Service takes a benevolent view, in an extreme case the lack of authority and a clear understanding of the policy behind the transferability requirement would make it difficult to marshal authority to support the perceived answer if challenged by the Service. Until the Service articulates a standard for applying the requirement, REITs should proceed with some degree of caution in crafting overly broad defensive entity-level ownership limitations.