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# Improving REIT acquisition analysis

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Property acquisition due diligence performed by a real estate investment trust requires a deep understanding of the asset class being acquired, the geographical area in which that asset resides, and perhaps most importantly, the normal day-to-day operations of the property.

The ambiguous nature of the REIT rules governing tenant services, including the determination of whether such services rendered are customary, can result in a great deal of uncertainty. However, while tenant services are often the focus, the greater issues may lie in who is performing services at the property, how are they compensated, and what special amenities do tenants enjoy. Ultimately, to the extent revenue generated from impermissible tenant services (ITSI) exceeds 1% for a particular property, all amounts received with respect to such property will not be considered rents from real property.

## CUSTOMARY SERVICES

At the center of the REIT income test requirements[1] is the definition of "rents from real property," which includes, in part, charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated.[2] Any property REIT due diligence will include reviewing a property management questionnaire (PMQ) filled out by the current property manager.

From a practical standpoint, the property manager may have little to no REIT experience, and their understanding of the questions being asked may not lead a REIT down the correct path. Ultimately, the PMQ should only be the starting point, and more detailed discussions with the property manager and further market research by the REIT or their advisors, is a must.

Whether or not services are "customary" can be very subjective in nature, and there is little guidance that could be relied upon. In fact, the largest source of information is contained in private letter rulings issued by the IRS; however such rulings may only be relied upon with respect to the taxpayer to whom the ruling was issued.[3] All determinations of "customary services" should be well documented, specifically citing what the norm is for such asset class in that geographical area.


## INDEPENDENT CONTRACTOR

Of course, it is important that REITs are able to provide a breadth of services that tenants of non-REIT owned assets in that particular geographical area enjoy. The REIT rules allow for an independent contractor (IK) exception, whereas non-customary services can be provided by such IK to the tenants. There are some obvious and some not so obvious issues that come up during a REIT property due diligence with regards to the use of an IK. The ownership rules regarding IKs is pretty straightforward[4], however, there is an additional requirement that the REIT cannot derive any income, regardless of the source, from such IK, and that the IK is adequately compensated at arm's length.[5]

This brings up a whole host of questions; is the IK a tenant (to which they pay rent) of the REIT? Is the IK a tenant only in the building in which the service is provided and only for the purpose of providing such service? Are all costs for non-customary services borne by the IK? Is a separate charge made for such services? Something as simple as the property manager renting space for a corporate office in the building (or another building in the REIT portfolio) would result in the REIT deriving income from such IK.

## PROBLEMS AND SOLUTIONS

It is a common misconception that as long as any non-customary services are performed by an IK, then there is not an ITSI issue. However, that is not always the case. For example, an IK provides certain ancillary non-customary services to which the tenants are not separately charged, and the landlord (REIT) reimburses the IK, then the revenue is imputed (calculated as 150% of such cost) and would result in ITSI.

If the tenant does reimburse the landlord, how that is effectuated is also important. Simple solutions may include changing the nature of the way such services are billed back to tenants, adding a taxable REIT subsidiary ("TRS") to the structure, or otherwise restructuring leases to preserve the IK relationship. In some cases, the REIT may need to discontinue use of certain service providers upon acquisition.

By nature, 1% would seem to be a small (de minimis) issue, and while the IRS does agree, the amount becomes more than "de minimis" as soon as the revenue exceeds 1%. Accordingly, there are no "small issues" when it comes to property level REIT due diligence. Ultimately, each IK relationship should be understood, each separate service vetted, and the asset class and geographical area should be sufficiently researched.

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[1] IRC §856(c)(2) requires that 95% of a REIT's gross income be derived from dividends, interest, rents from real property, and other gains on sale of stock and real property.
IRC §856(c)(3) requires that 75% of a REIT's gross income be derived from rents from real property, interest on mortgages, and real property gains.
[2] IRC §856(d)(1)(B)
[3] IRC §6110(j)(3)
[4] IRC §856(d)(3) – generally the REIT does not own more than 35% of such IK and the IK does not own more than 35% of the REIT
[5] IRC Reg. §1.856-4(b)(5)