

Preface

Origins and Early Growth of the REIT Market

In 1960, Congress enacted legislation establishing the REIT, a vehicle allowing income from real estate to be distributed to stockholders without the imposition of corporate-level tax. Sixty years later, REITs are a critical factor in the financing and ownership of interests in real estate. REIT shares are traded on national securities exchanges in significant numbers and values. Private REITs feature prominently in private funds and asset syndications. Public non-traded REITs provide investors with access to real estate in a manner not correlated to the behavior of stock markets. In fact, the success of REITs in the U.S. has led to the adoption of the concept around the world.

The year 1960 did not see the invention of tax-efficient real estate investment, as Massachusetts business trusts had served some of the function of REITs before 1960. Nor did REITs introduce syndications to the world. Syndications have existed since at least Mesopotamian times, if not earlier.¹ But 1960 can be seen as a seminal moment in contemporary real estate capital markets by virtue of the establishment of the actual vehicle that is now so widely used.

REITs did not take off right away. By year-end 1972, the total market capitalization of the sector stood at a paltry \$1.5 billion. It fell further to a year-end nadir of \$700 million during the oil shock/stagflation recession of 1973-74. But afterwards, REIT total market capitalization increased exponentially, hitting year-end \$1 trillion for the first time in 2016, where it has stayed.²

REIT success was greatly spurred on by the Tax Reform Act of 1986 (TRA 1986). By essentially abolishing the long-term tax benefits of real estate-generated passive losses, the TRA 1986 eliminated the motivation to create bookkeeping losses and thereby emphasized real estate investment for income generation and capital appreciation. REITs, which do not pass through tax losses and which are intended to be managed for income generation and capital appreciation, began to look better. As long as a REIT complies with the rules, its income is taxed only once—i.e., at the stockholder level. Equity REITs, mortgage REITs and hybrid REITs now compete favorably for the investor's dollar.

The REIT industry has now passed the 29th anniversary of what some commentators call the Modern REIT Era. That period commenced in 1991 with the Kimco IPO, followed by the Taubman offering, the first umbrella partnership real estate investment trust (UPREIT), in 1992. At this time, the industry was not well regarded, following the collapses of the mortgage REIT market in the 1970s and of the commercial real estate market in the 1980s and the subsequent failures of many savings and loan institutions. In 1991 the equity market capitalization of the REIT sector was only \$13 billion, compared to over \$1.3 trillion as of December 31, 2019.³ 2020 also saw the 19th anniversary of REITs breaking into the Standard & Poor's indexes.⁴ 2020 was also the 20th anniversary of the worldwide REIT index, now known as FTSE EPRA/Nareit Global Real Estate Index, showing the worldwide ac-

¹ For a take on the early history of REITs and other syndications, see Evan Hudson, *In the Beginning Was the REIT*, Bloomberg Tax, December 10, 2019.

² See *Id.*

³ <https://www.reit.com/sites/default/files/reitwatch/RW2001.pdf>.

⁴ Bryce Blair, *Milestones in the Modern REIT Era*, REIT Magazine, September- October 2011, p. 4; Ralph Block, *Reflections on a REIT Revolution*, REIT Magazine, November-December 2011, p. 66; and Anna Robaton, *Property Goes Public*, REIT Magazine, November-December 2011, p.26; Donald Wood,

ceptance of REITs.

The period 2012-14 saw the Empire State Building, the most visible icon of New York City, converted to REIT status, amidst a degree of controversy.⁵ Other mainstays of American commerce, including Sears and Macy's, contemplated putting all their store locations into REITs.⁶ But tax law changes adopted in 2015 put a crimp in the movement to convert C corporations to REITs.

In 2016 REITs took a major step in market recognition, when S&P and MSCI recognized real estate (other than mortgage REITs) as a separate asset class (as one of 11 major industry classes), elevated from its prior role as a component in the Financials Sector classification. This was the first change to the S&P 500 Index groups in almost 20 years. The 28 REITs that were previously buried in the Financials Sector and that were the subjects of the rearrangement now number 30 and have a market value of more than \$697 billion as of April 30, 2020.⁷ This change led to greater investor awareness of real estate as a sector.

The big news for REITs in 2018 was the impact of the December 2017 Tax Cuts and Jobs Act (TCJA). As detailed below, this change to certain fundamentals of tax law had a major impact on many forms of investments, including REITs.

The first half of 2020 saw the dismal trifecta of pandemic, financial crisis and civil unrest. The effects on commercial real estate, the capital markets and the federal budget have appeared in a moribund leasing and investment sales market, eviction moratoriums, rent arrearages and deficit spending on fiscal stimulus. In the most visible sign of investor sentiment relevant to REITs, the MSCI US REIT Index plunged 45.74% from its all-time high of 1,360.13 on February 21, 2020 to a nadir of 738.02 on March 23, 2020 before rebounding a certain amount and stabilizing as of the date of this writing in early June.

Legislative Reforms

REIT legislation has been passed on a regular basis. The Taxpayer Relief Act of 1997 contained many provisions affecting REITs. The Work Incentives Improvement Act of 1999, by introducing the concept of a taxable REIT subsidiary (TRS) to furnish noncustomary services to tenants and others, enhanced REITs' ability to

The Modern REIT Era Turns 20, REIT Magazine, November-December 2011, p.6.

⁵ Three groups of investors each held 1,100 units in Empire State Building Associates (ESBA) (which originally were sold for \$10,000 per unit in 1961). The REIT conversion plan combined the Empire State Building with certain other area buildings into the Empire State Realty Trust Inc. The conversion needed to be approved by the holders of at least 80 percent of the units in each of the three groups. See Charles V. Bagli and Julie Creswell, *A Nasty, Epic Real Estate Battle With Stakes 102 Stories High*, New York Times, April 29, 2013, p. B1; *The Tangled Tale Behind an Icon's IPO*, Bloomberg BusinessWeek, August 30, 2012, p. 40, available at <http://www.businessweek.com/articles/2012-08-30/the-tangled-tale-behind-the-empire-state-buildings-ipo>; Iaina Jones, *Empire State Building investors to vote on REIT proposal*, Reuters, January 22, 2013, available at <http://www.reuters.com/article/2013/01/22/us-usproperty-empirestate-idUSBRE90L00720130122>. After the settlement of a lawsuit from holdout investors who voted against the conversion, at least four unsolicited bidders made offers to buy the building. On October 1, 2013, Empire State Realty Trust Inc. went public, selling 71.5 million shares for \$13 each, for total proceeds of \$929.5 million, the second-largest REIT IPO after a 2006 offering by Douglas Emmett Inc. David M Levitt, *Empire State Realty Trust Gains After \$929.5 Million IPO*, Bloomberg, October 2, 2013, available at <http://www.bloomberg.com/news/articles/2013-10-02/empire-state-realty-trust-gains-after-929-5-million-ipo>. Another lawsuit, by a plaintiff which sought class-action status, claimed in December 2013 that the sponsors acted in bad faith by aborting a "bidding war" for the building, and instead enriched themselves by hundreds of millions of dollars through an IPO. The judge dismissed the case in July 2014 on the grounds that the investors had waived their right to sue when they agreed to the aforementioned settlement. Jonathan Stempel, *NY judge throws out lawsuit by Empire State Building investors*, Reuters, July 22, 2014, available at <http://www.reuters.com/article/2014/07/22/us-lawsuit-emp-state-real-idUSKBN0FR26W20140722>.

⁶ Mike Calia, *Sears targets REIT formation in May or June*, MW Market Watch, February 26, 2015, available at <http://www.marketwatch.com/story/sears-targets-reit-formation-in-may-or-june-2015-02-26-64855217>.

⁷ reit.com/sites/default/files/reitwatch/RW2005.pdf

compete aggressively for tenants. However, the Jobs and Growth Tax Relief Reconciliation Act of 2003, which provided a 15% tax rate for most corporate dividends (now 20%), retained the ordinary income tax rate for REIT dividends, thereby disfavoring REITs. This changed the after-tax relationship of most corporate dividends and REIT dividends for taxable entities, but did not affect the desirability of REIT dividends for pension plans and other tax-exempt entities. The former was somewhat mitigated by the 20% deduction on REIT dividends in the TCJA, as addressed below. Other legislation with REIT provisions includes the American Jobs Creation Act of 2004, the Gulf Opportunity Zone Act of 2005 and the Tax Increase Prevention and Reconciliation Act of 2005.

The Federal Housing Finance Regulatory Reform Act of 2008 included a section devoted to REIT-related tax reforms referred to as “The Housing Assistance Tax Act of 2008.” It incorporated many of the well-needed REIT reforms proposed in the REIT Diversification and Empowerment Act, first introduced in 2006. The changes included a reduced holding period needed to meet the prohibited transactions safe harbor, an increase in the percentage of securities that can be held in a TRS (now reversed), clarification of the rules that determine when currency gain recognized by a REIT from a qualified business unit (QBU) of the REIT is qualifying income for purposes of the 95% and 75% income tests, the exclusion of hedging transaction income from gross income for purposes of the 75% income test (it previously was excluded only for purposes of the 95% test) and a provision clarifying that rent paid to the parent REIT by TRSs that hold healthcare facilities operated by independent contractors constitutes qualified real estate-related income for purposes of both income tests.

The favorable tax status of REITs comes under scrutiny by Congress from time to time. For example, on February 25, 2014, David Camp, then the House Ways and Means Committee Chairman, proposed a dramatic overhaul of the Internal Revenue Code of 1986, as amended (the Code), a proposal that included significant limitations on the tax-favored status of REITs. However, these proposals did not gain traction.

REIT regulations proposed in 2014 were intended to codify certain portions of the expanded definition of real property.⁸ On August 31, 2016, the Treasury Department finalized the regulations defining real property for a REIT.⁹ The final regulations generally follow the proposed regulations, though with several important changes.¹⁰

The finalized regulations were intended to be consistent with existing published guidance defining real property for REIT purposes by, among other things, more precisely defining real property and providing a safe harbor list of real estate assets. Consistent with Section 856, the prior regulations, and published guidance interpreting those regulations, real property was defined to include land, inherently permanent structures and structural components. The regulations also provide a framework for determining the proper characterization of property that is not specified in the regulations.

These regulations are helpful in that they codify most of the favorable positions that the IRS has taken in the rulings it has issued, along with the framework that it generally has used in evaluating whether assets constitute real property. This should both reduce the number of private letter rulings on REIT issues being sought from the IRS and facilitate a smoother REIT compliance regime. However, the regulations do not purport to deal with the REIT income tests. Thus, although a particular asset may qualify as a real estate asset, income earned from such asset

⁸ REG-150760-13.

⁹ T.D. 9784.

¹⁰ See § 2:16.50 for further details.

may not be considered as “rents from real property” under the REIT rules.

The PATH Act¹¹ that was signed into law on December 18, 2015 made a number of changes to the tax treatment affecting REITs. Included among them were restrictions on spinoffs of REITs,¹² a reversion to 20% of the percentage of a REIT’s assets that can consist of TRSs,¹³ changes to the prohibited transaction safe harbor,¹⁴ the repeal of the preferential dividend rule for publicly offered REITs,¹⁵ modifications to the hedging exception,¹⁶ a 100% tax on certain services provided by TRSs,¹⁷ an increase in the percentage of stock of a publicly traded REIT that can be exempt from the FIRPTA tax¹⁸ and an increase in the withholding tax rate on sales of REIT stock that are not exempt from withholding (to 15%).¹⁹

On June 8, 2016, the IRS adopted final and temporary regulations²⁰ and proposed regulations²¹ that provide for a 10-year recognition period for companies that convert to or are acquired in tax-free transactions by a REIT, even though the PATH Act had made a five-year period permanent for a similar recognition period with S corporations.²² These regulations also closed what the IRS viewed as potential loopholes in the REIT spinoff legislation. Nareit submitted comments on the regulations.²³ On January 18, 2017, the IRS issued new finalized regulations²⁴ reducing from ten years to five years the recognition period for the corporate-level tax imposed on such property dispositions by REITs, and otherwise generally adopting the approach set forth in prior temporary and proposed regulations.

The TCJA made substantial changes to the Code that affect REITs in various ways.²⁵ Corporate income taxes, previously having a progressive rate structure with a maximum rate of 35%, now have a flat rate of 21%. The corporate alternative minimum tax was eliminated. Newly created net operating losses (NOLs) were allowed to be carried over indefinitely, though they could offset only 80% of the income of a corporation and could not be carried back. The deductibility of interest was limited to 30% of a business’s adjusted taxable income, though an elective exception for real estate was provided. The legislation also added a very favorable rule for REIT dividends; for individuals and trusts, in the case of REIT dividends that do not qualify for the favorable capital gains rates, a 20% deduction was included to reduce the maximum federal income tax rate (putting aside the 3.8% Medicare tax) from 37% to 29.6%.

¹¹ (P.L. 114-113, 12/18/2015).

¹² See § 1:59 for further details. In a 2016 transaction that would work even after the ban on REIT spinoffs, MGM created a “captive REIT,” which is around 70 percent owned by MGM, and sold stock in the REIT in an IPO. While this model is less tax efficient than a complete spinoff, it does not require an IRS ruling, and allows MGM to maintain more control over the properties, a common concern among corporations thinking about transferring real estate holdings to a REIT.

¹³ See § 3.5 for further details.

¹⁴ See § 1:59 for further details.

¹⁵ See § 1:59 for further details.

¹⁶ See § 1:59 for further details.

¹⁷ See § 3.9 for further details.

¹⁸ See § 1:59 for further details.

¹⁹ See § 1:59 for further details.

²⁰ TD 9770.

²¹ REG-126452-15.

²² See § 4:42 for further details.

²³ [https://www.reit.com/sites/default/files/Nareit-Submission-on-Proposed-337\(d\)-Regulations\(7-19-16\).pdf](https://www.reit.com/sites/default/files/Nareit-Submission-on-Proposed-337(d)-Regulations(7-19-16).pdf).

²⁴ TD 9810.

²⁵ See § 1:59 for further details.

On March 27, 2020, federal legislation intended to ameliorate the economic impact of the COVID-19 pandemic, the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act), was signed into law. The CARES Act made technical corrections, or temporary modifications, to certain of the provisions of the TCJA Act. The CARES Act increases the aforementioned interest limitation to 50% for taxable years beginning in 2019 or 2020 (with special rules applicable to interest allocation from entities treated as partnerships for tax purposes) and permits an entity to elect to use its 2019 adjusted taxable income to calculate the applicable limitation for its 2020 taxable year.

The *CARES Act* also allows taxpayers to carry back NOLs from tax years beginning in 2018, 2019 or 2020 for up to five years. In addition, for taxable years beginning before January 1, 2021, the *CARES Act* removes a limitation on NOLs that prevents taxpayers from offsetting in excess of 80% of taxable income with NOLs. REITs, however, may not carry back losses, and losses may not be carried back to any REIT year (regardless of whether the taxpayer incurring the loss is currently a REIT).

The Inflation Reduction Act of 2022 (the “IRA”), was signed into law on August 16, 2022, and includes new Code Section 6418, which allows REITs to benefit from energy-related tax credits. Historically, energy-related tax credits did not generate qualifying REIT income, and the assets used to generate such credits were not qualifying REIT assets. Due to these limitations, many REITs owned solar panels through TRSs, which result in corporate taxes on such income. The IRA makes it easier for a REIT to overcome these limitations.

Specifically, the IRA allows REITs to sell certain energy tax credits to unrelated taxpayers for cash, and the cash received is not treated as gross income to the REIT. Assuming the REIT does not sell the electricity to a third party, the REIT would not be treated as having any income from the energy producing facility. This does not solve for the asset test, but that generally is less difficult to satisfy. In the preamble to proposed regulations issued on June 21, 2023, the Treasury Department and the IRS indicated that they “do not believe” that the sale of such credits would not result in a “prohibited transaction” that is subject to a 100% penalty tax.

On December 29, 2022 proposed regulations (the “Proposed DREIT Regulations”) were issued relating to the qualification of a REIT as a domestically controlled real estate investment trust (a “DREIT”). Final regulations (“Final DREIT Regulations”) were issued on April 23, 2024.

As a general matter, any gain or loss of a non-U.S. investor from the disposition of a U.S. real property interest (a “USRPI”) is considered to be income that is effectively connected with the conduct of a U.S. trade or business, and subject to U.S. tax. A USRPI includes an interest in a REIT with 50% or more of the fair market value of its assets consisting of interests in U.S. real property.

However, an interest in a DREIT is not a USRPI, and thus the sale of a DREIT by a non-U.S. investor is not subject to U.S. tax. A DREIT is a REIT in which less than 50% of the value of its stock is held directly or indirectly by foreign persons during certain prescribed periods.

Before the issuance of the Proposed DREIT Regulations, non-U.S. investors often acquired U.S. real property through a REIT that was partially owned by a U.S. corporation that was 100% owned by the non-U.S. investor. The intent was that the U.S. corporation be treated as a U.S. investor for purposes of the DREIT 50% test. The Proposed DREIT Regulations would look-through non-publicly traded domestic corporations that own a 25% or greater interest in a REIT for purposes of testing domestically controlled REIT status. The Final DREIT Regulations generally adopt the recommendations in the Proposed DREIT Regulations, though they modify the “25% or greater” threshold to a “more than 50%” threshold. The Final DREIT Regulations also include a new transition rule that, subject to certain requirements, exempts REITs already in existence on April 24, 2024, from the

limited look-through rule for domestic C corporations for a 10-year period.

Industry chatter indicates that the IRS is working on regulations governing REIT income.

Ways to Invest in REITs

Over the years there has been an increase in the number of ways to invest in REITs, including an ongoing expansion of Section 401(k) plans offering REIT shares as well as the growth in REIT index funds and exchange-traded funds (ETFs) based on REIT sector indexes. Index funds and ETFs generally charge low fees and allow the investor to obtain diversification among REITs. For an investment with low correlation to the equity markets, investors may also access non-traded REITs, public REITs whose shares are not listed on any securities exchange.

Factors Affecting the Number of REITs²⁶

IPOs. IPOs, those dramatic births of publicly traded REITs, in general have declined in number the past few decades. The 1990s witnessed an explosion in the number of publicly traded REITs coming to market and a growth in the total number of publicly traded REITs. Following a dip around the turn of the millennium, there was a boom in 2004, with 29 IPOs, in retrospect fueled by a bubble economy. The number then started downward again. While the financial crisis of 2008-09 saw some interesting new mortgage REITs form to take advantage of a fortuitous confluence of cheap government financing and a dearth of lending by banks and life insurance companies,²⁷ the number of publicly traded REIT IPOs didn't peak again until 2013, when 19 went public. Since then, the number has not exceeded nine in any year.²⁸

Mergers and Acquisitions. During the period from 2004 until mid-2007 merger and acquisition activity in the REIT area was very active, including both mergers of public REITs with other public REITs and acquisitions by private investment vehicles, spurred by a surfeit of capital in the private investment market. In 2006 and 2007, the significant trend was for many public REITs to go private. That boom ended in late 2007, however, and it turned out that many of the private companies acquiring REIT assets overpaid. Some paid the ultimate price, as Lehman Brothers Holdings found out with its abysmal purchase (along with Tishman Speyer Properties LP) of apartment developer Archstone-Smith Trust, the second-largest US apartment REIT, for \$22 billion (including assumed debt) in October 2007, which played a part in Lehman's bankruptcy in late 2008. While the mergers and acquisition market slowed after the economic crash in 2008, remaining relatively stagnant from 2009 through 2012, activity began to pick up again in 2013, culminating in 2018 with deals valuing \$76.3 billion, the highest number since 2007.²⁹

²⁶ See § 1:62 and § 1:63 for details on the numbers discussed here. Certain information comes from Nareit ReitWatch for January 2013, available at <http://returns.reit.com/reitwatch/rw1301.pdf>.

²⁷ *Mortgage REIT IPOs: There Is Vibrant Life After Death In CRE Debt*, REITwrecks, July 26, 2009, available at <http://www.istockanalyst.com/article/viewarticle/articleid/3372101>. Possible activities by these types of REITs include first mortgage originations, senior participations in fixed and floating first mortgage loans, origination and acquisition of CMBS using TALF money, investment in B-note and mezzanine loans, and financing for third-party purchases of CRE notes and first mortgages.

²⁸ Data from 2018 through 2019 from Nareit REITWatch for January 2020 "Historical Offerings of Securities" (Exhibit 4), available at <https://www.reit.com/sites/default/files/reitwatch/RW2001.pdf>. Data for earlier years obtained as follows: 2011 through 2017 from Nareit REITWatch for January 2018 "Historical Offerings of Securities" (Exhibit 4), 2006 through 2010 from Nareit REITWatch for January 2015 "Historical Offerings of Securities" (Exhibit 4), 2004 through 2005 from Nareit REITWatch for January 2013, "Historical Offerings of Securities" (Exhibit 4); 2000 through 2003 from Nareit REITWatch for January 2009, Table 5; and 1992 through 1999 from Nareit REITWatch for January 2000, Table 5 (each available, if currently available at the same website, changing RW1801 to RW[year]01).

²⁹ Derived from Nareit REITWatch for January 2020, "U.S. REIT Merger and Acquisition Activity"

Bankruptcies. It has been rare for REITs to file for bankruptcy; instead, troubled REITs would be candidates for takeover by private equity. But during the subprime crisis of 2007-09 we saw some bankruptcy activity, with two major public REITs filing for bankruptcy protection (one mall operator in 2009 and one hotel operator in 2010). Another major REIT in the warehouse field was able to avoid bankruptcy, however. One non-traded mortgage REIT was forced into bankruptcy in 2011. As of this writing, the Covid-19 pandemic has resulted in several Chapter 11 filings by publicly traded REITs: Pennsylvania Real Estate Investment Trust, a mall REIT, which entered Chapter 11 on November 1, 2020³⁰ and emerged on December 11, 2020;³¹ CBL & Associates Properties, Inc., another mall REIT, which entered Chapter 11 on November 2, 2020;³² and Eagle Hospitality Trust, a Singapore-based hotel REIT listed on the Singapore Stock Exchange, certain of whose US subsidiaries entered Chapter 11 on January 19, 2021.³³

De-REITing. The subprime crisis led at least one REIT to give up REIT status due to the burden of the annual distribution requirements. NovaStar announced that it was “throwing in the REIT towel” because it could not afford the \$157 million dividend it would have to pay to maintain REIT status.³⁴ The move gave rise to a substantial tax liability that was, however, offset by deductible losses. While unusual, such “de-REITing” elections are not unheard-of, particularly in depressed markets. The lack of liquidity that many REITs faced in 2009 due to their inability to borrow money led to certain companies taking advantage of a one-year “special deal” from the IRS allowing them to pay their required dividend in the amount of 90% of net taxable income in the form of stock. Some of the largest REITs used this special procedure, although few others did.³⁵

REIT Numbers. At the end of 2008, following widespread consolidation and going-private activity, there were only 136 publicly traded REITs; that number has grown almost continuously every year since then until, by the end of 2019, the number of publicly traded REITs, 226, equaled a peak number last seen in 1994. The growth in numbers indicates both a growth in the number of new REITs (especially in nontraditional asset classes) and a decline in the number of consolidations.³⁶

Publicly Traded REIT Values

Publicly traded REIT values disproportionately reflect two things: the ups and downs of the real estate market, and the dynamics of the public equities market. The real estate market and the public equities market are different things, and not particularly correlated to one another, but anyone looking at the values of publicly traded REITs needs to be aware that both inputs combine to produce what is being

(2004–2019), pp. 28–29, available at <https://www.reit.com/sites/default/files/reitwatch/RW2001.pdf>.

³⁰ See PREIT press release of November 1, 2020, available at <https://www.sec.gov/Archives/edgar/data/77281/000119312520284830/d44373dex991.htm>.

³¹ See PREIT press release of December 11, 2020, available at <https://www.sec.gov/Archives/edgar/data/77281/000119312520319147/d54310dex991.htm>.

³² See CBL press release of November 2, 2020, available at https://www.sec.gov/Archives/edgar/data/910612/000156459020049434/cbl-ex994_7.htm.

³³ See Eagle Hospitality Trust Update Announcement of January 20, 2021, available at https://investor.eagleht.com/newsroom/20210120_100035_LIW_VN624VNA3XB24UY8.1.pdf.

³⁴ *NovaStar Ending its Status as an REIT*, New York Times, September 18, 2007; Gretchen Morgenson, *Creative Loans, Creative Compensation*, New York Times, November 18, 2007, Business Section, p. 1; available at <http://dealbook.blogs.nytimes.com/2007/09/18/novastar-ending-its-status-as-a-reit/>.

³⁵ See § 4:11 and § 12:203.

³⁶ Nareit REITWatch for January 2020, p. 20, available at <https://www.reit.com/sites/default/files/reitwatch/RW2001.pdf>.

looked at. Of course other factors come into play, things like interest rates and foreign capital flows, the vagaries of which are best parsed by economists and market professionals. All that said, what follows is a high-level summary of what the publicly traded REIT markets have been doing for the past 15-plus years.

For the period through mid-2007 there were seven years of rising values for REITs. By the end of 2006 the 183 publicly traded REITs tracked by Nareit had a market capitalization of \$438 billion. Values peaked in February 2007. This was a time of increasingly higher (and unsupportable) valuations of most real estate, along with loose underwriting standards for mortgages for subprime borrowers. 2007 saw the early phases of a fallout in the REIT market that inevitably arose from profit-taking following the seven-year upward ride in prior years (with total return of about 300% since the end of 1999), as well as fallout from the housing crisis of mid-year triggered by problems in the subprime market and the steady increases in interest rates. The FTSE Nareit All REIT Index was down 17.83% for the year. On balance, the REIT sector performed markedly worse in 2007 than the market at large.

The downtrends of 2007 continued into 2008 and accelerated with the stock market meltdown that affected the entire market, especially in the September 28th collapse following the failure (at first) of the U.S. House of Representatives to pass the stock market “bailout” bill, with the commercial real estate market being especially hit badly due to fear of the general tightening of credit.³⁷ Commercial real estate values dropped some 30 to 40% from their recent highs; REIT values dropped commensurately. The FTSE Nareit All REIT Index was down 37.34% for 2008. The REIT sector, however, paralleled the market at large, where the S&P 500 was down 37.00%, the DJIA was down 33.84%, the Russell 2000 was down 33.79% and the NASDAQ Composite was down 40.54%.³⁸ By the end of 2008 the aggregate market capitalization for the 136 publicly traded REITs tracked by Nareit at that time was only \$191 billion, a drop of 25% by number of REITs and 56% by market capitalization from the high-water mark of early 2007.

Though not without interruption, the post-financial crash world has seen a turnaround. At the end of 2009, the 142 publicly traded REITs had a market capitalization of \$271 billion, an increase of 42% from the prior year-end; at the end of 2012, the 172 REITs in the FTSE Nareit All REIT Index had a market capitalization of \$603 billion, an increase of 122% from year-end 2009 values and a 34% increase for the year. The valuation continued to increase steadily every year from 2013 until 2017, when the 222 tracked REITs had a market capitalization of \$1.134 trillion. The year 2018 saw a temporary decrease (with the 226 tracked REITs having a market capitalization of \$1.048 trillion). There was a return to growth in 2019 (with the 226 tracked REITs having a market capitalization of \$1.329 trillion, a one-year growth of over 25%, with the number of REITs remaining constant).³⁹

The bottom of the REIT market is generally thought to have occurred in March 2009. REIT share prices have sprung back, returning on average 7.73% per year for the 10-year period ended December 31, 2017, though still slightly underperforming the S&P 500, the NASDAQ Composite, the DJIA and the Russell 2000 over that period.

The FTSE Nareit All Equity REIT Index was down 4.04% in 2018 and rebounded to go up 28.66% in 2019, which was a mixed performance as compared to the S&P

³⁷ *Sector Snap: REIT Shares Amid Market Sell-Off*, September 29, 2008, available at <http://www.forbes.com/feeds/ap/2008/09/29/ap5485283.html>.

³⁸ Nareit REITWatch for January 2015, p. 20, available at <https://www.reit.com/sites/default/files/reitwatch/RW1501.pdf>.

³⁹ Nareit REITWatch for January 2020, p. 20, available at <https://www.reit.com/sites/default/files/reitwatch/RW2001.pdf>.

500, the NASDAQ Composite, the DJIA and the Russell 2000. The mixed results for the last two years also resulted in REITs underperforming some of these markets, while outperforming others, for each of the 3-, 5-, 10- and 15-year periods ended December 31, 2019, while exceeding the other markets in each of the 20-, 25-, 30-, 35- and 40-year periods then ended, other than the S&P 500 over the 35-year period.⁴⁰

The minor downturn of 2018 was driven by concerns over rising interest rates and fears that property values were peaking. That negative outlook on REITs led to pressure from the public to become more aggressive, with some upheavals in board composition. For example, in 2018, nine of the thirteen members of the board of Forest City Realty Trust agreed to resign, in the wake of efforts by the company to sell the business. It had previously sold off its subsidized housing and mall properties and eliminated its dual-class stock structure, thereby reducing the influence of its founding family.⁴¹ It was subsequently acquired by an affiliate of Brookfield Asset Management.

Public Equity Offerings by Traded REITs

More seasoned REITs have been tapping into the public market over the last decade. Since 2009, REIT offerings (initial public offerings, secondary equity and secondary debt) increased by an average of 219 offerings per year, and raised an average of \$76.9 billion per year. By comparison, there were 82 offerings in all of 2008, totaling approximately \$18 billion.⁴² It is worth noting that the debt load of REITs in 2009 and 2010 was significant due to the fact that many of the offerings were “defensive,” *e.g.*, follow-on offerings by large REITs seeking to replace burdensome debt with equity (sometimes called “re-equitization” since the debt was traded for equity), rather than “offensive,” *e.g.* raising capital for acquisitions.⁴³ The preference towards “defensive” offerings continued even after the financial crisis.⁴⁴ The majority of recent offerings, however, have been “offensive.”

While most REITs go public by forming the entity and then selling shares in the public market, REITs can also be formed “through the back door,” with a publicly traded special purpose acquisition company (SPAC or “blank check” company) acquiring a private real estate company and thereby taking it public. SPACs raise equity from investors despite not having an actual business; they then have to get stockholder approval to form or merge with a specific business within a defined timeframe, usually two years after the initial stock issuance.⁴⁵ As of this writing, a publicly traded REIT, Simon Property Group, has even sponsored its own SPAC.⁴⁶ It seems likely that more will follow suit.

⁴⁰ Nareit REITWatch for January 2020 “Investment Performance: FTSE Nareit US Real Estate Index Series” (Exhibit 1) and “Selected Indicators of Equity Market Performance” (Exhibit 3), available at <https://www.reit.com/sites/default/files/reitwatch/RW2001.pdf>.

⁴¹ Esther Fung, *REIT Boards Feel Heat From Sinking Shares*, Wall Street Journal, April 11, 2018, p. B6, available at <https://www.wsj.com/articles/forest-city-board-shake-up-could-be-a-harbinger-for-other-reits-1523380420> (as *Forest City Board Shake-Up Could Be a Harbinger for Other REITs*, April 10, 2018).

⁴² Nareit ReitWatch for January 2020, “Historical Offerings of Securities” (Exhibit 4), available at <https://www.reit.com/sites/default/files/reitwatch/RW2001.pdf>.

⁴³ Nareit ReitWatch for November 2009, “REIT Industry Fact Sheet” (Page 3), available at <https://www.reit.com/sites/default/files/media/Portals/0/PDF/RW0912.pdf>.

⁴⁴ Nareit ReitWatch for January 2020, “Historical Offerings of Securities” (Exhibit 4), available at <https://www.reit.com/sites/default/files/reitwatch/RW2001.pdf>.

⁴⁵ See “SPACs and Real Estate,” Stroock Client Alert, October 29, 2020, available at <https://www.stroock.com/news-and-insights/spacs-and-real-estate>.

⁴⁶ The latest version of the preliminary prospectus available as of this writing is available at https://www.sec.gov/Archives/edgar/data/1839127/000110465921022134/tm212034-7_s1a.htm.

While recognizing the interest rate-sensitive nature of REITs and the concern with price “bubbles,” many believe the REIT industry will continue to expand. The importance of REITs in today’s economy can be noted from the fact that as of December 2019 there were 118 on S&P’s three primary indices, up from 39 in 2006.⁴⁷ These figures are impressive, especially when you realize that it was not until 2001 that REITs were included in any major S&P indices.

In 2005 REITs were accorded the status of an industry in the MSCI Barra and S&P Global Industry Classification Standard, with seven REIT sub-industries: diversified, industrial, mortgage, office, residential, retail and specialized.⁴⁸ In 2016 S&P and MSCI recognized real estate as a separate asset class, elevated from its prior role as a component in the Financials Sector classification. Mortgage REITs, however, remain in the Financials Sector. This gave rise to some fancy footwork at various index funds to ensure that the stocks in their portfolio tracked the current financial-sector benchmarks.⁴⁹ It is expected that this change will further highlight the importance of the real estate (and REIT) industry.

What This Book Covers

This book discusses the legal, business and investment aspects of REITs. It reviews the organization of a REIT, including the decision whether to form a REIT and its state of formation. It analyzes the requirements for a company to qualify as a REIT, including statutory requirements, asset and income tests, and investment rules. It discusses issues of relevance to REIT investors, including the types of permitted investors, access points to the REIT market, tax preferences and rules, and financial reporting metrics. It explores the tax characteristics of REITs, including their pass-through nature and the nuances of dividends, capital gains, prohibited transactions, distribution requirements, safe harbor rules, and tax-free provisions.

There are special chapters on UPREIT and DownREIT structures, on mortgage REITs, on state and local tax issues relating to REITs and on real estate issues relevant to REITs and discussions of private REITs, non-traded REITs, specialized REITs, REIT spin-offs and foreign investment in U.S. REITs.

In addition to the foregoing, there is an analysis of the securities law aspects of REITs, including registration, continuing disclosure issues, requirements of self-regulatory organizations such as the New York Stock Exchange (NYSE) and NASDAQ Stock Market and state law compliance. Governance issues are also discussed.

The book contains appendices with several model REIT prospectuses and model organizational documents. The appendices include material related to tax issues, including Code sections, regulations, and discussions of private letter rulings and other less commonly available tax material. The statement of policy by the North American Securities Administrators Association regarding REITs and Nareit materials on Funds from Operations and IPA materials on Modified Funds from Operations are also included.

New Material

This 2024 update includes new or expanded discussion of the following areas, among others:

- Updated summaries of PLRs issued by the IRS in connection with REIT issues.
- Current statistics regarding the role of REITs in the investment community, including recent growth in the number and market capitalization of REITs,

⁴⁷ Current figures from ReitWatch for January 2020, p. 21, available at <https://www.reit.com/sites/default/files/reitwatch/RW2001.pdf>. For a listing by members as of July 2020, see *REIT Membership in the S&P Indexes*, available at <http://www.reit.com/IndividualInvestors/REITsinSPIndexes>.

⁴⁸ *REITs Gain GICS Industry Status*, Nareit NewsBrief, December 2005, p. 2.

⁴⁹ Daisy Maxey, *Shedding REITs to Cut Yields at Some Funds*, Wall Street Journal, August 22, 2016.

historic and current figures for the relative roles of various sectors of the REIT industry, dividend yields, total annual return, number of REITs in the Standard & Poor's primary indexes, securities issuances and structural changes (consolidations, acquisitions and bankruptcies) and recent market trends and performance, particularly impacted by the COVID-19 pandemic and the recent volatility in interest rates.

- Proposed regulations modifying the requirements for REITs to be treated as domestically controlled REITs.
- New legislation and proposed regulations permitting REITs to sell tax credits generated from solar power and certain other energy sources.
- The structure and operation of non-traded REITs.
- The growth of Opportunity Zone funds and special purpose acquisition companies and their implications for REITs.
- The various methods to analyze REIT performance, with a particular focus on the Nareit Funds from Operations and the IPA Modified Funds from Operations benchmarks, as well as the recommendations provided by the IPA Valuations Practice and IPA Per Share Investment Performance Reporting guidelines.
- Specific types of provisions, covenants, fee arrangements, representations and warranties contemplated during REIT mergers, as well as protections, tactics and real-world examples involving hostile takeovers.
- REIT considerations in the area of transactional real estate, specifically when acting as tenant or joint venture or borrowing under senior mortgage loans, and a discussion of the structure and risks of mezzanine financing and issuing mortgage loans.
- 2024 proxy recommendations by ISS and Glass Lewis.
- 2023 SEC amendments to Regulation S-K regarding the public disclosure requirements relevant to cybersecurity policies and incidents.
- Ongoing SEC proposals regarding climate change disclosure requirements.
- 2022 proposals by NASAA to revise the NASAA Statement of Policy regarding Real Estate Investment Trusts.
- Recent changes to the NYSE and NASDAQ direct listing rules.
- SEC, NYSE and NASDAQ guidance and recommendations on disclosures related to workforce diversity and environmental, social and governance information.
- Regulations of mini-tender offers as applicable to REITs.

We hope that this volume will assist lawyers, accountants, REIT investors, REIT administrators and real estate professionals as a source of information and ready reference.