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Introduction

Now in its eighth edition, EY’s *Perspectives on risk: 2015 REIT report* is intended to help real estate investment trusts (REITs) and other property investors make more informed decisions.

This year’s report focuses on the issues that are most top of mind for REIT executives, including:

- Succession planning
- Cybersecurity
- UPREIT traps
- Properly structuring taxable REIT subsidiaries

We hope that you will find this report valuable and helpful in making decisions that will enhance your organization’s success.

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Global Real Estate, Hospitality and Construction Leader  
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Executive summary
How REITs can address the risks that concern them the most

Today the boards and senior management of REITs must address the same strategic risks as their counterparts in the corporate world. In addition, REIT leaders must address risks that are particular to REITs and real estate. EY polled a group of REIT executives to understand what issues are considered top of mind. Among those of concern are:

- Succession planning: while succession planning is an issue for companies generally, it is of particular concern to REITs because after years of low turnover we have seen a recent increase in CEO departures that we expect will continue. The complexity of the CEO role means that individuals need a wide array of skills, and these are best developed over time through an extensive talent management program.
- Cybersecurity: every company must address the risks of cyber attacks and breaches of security. In addition to the risk of exposing confidential or sensitive information, REITs have the added risk of attacks that could compromise or disable the physical security of their buildings.
- Tax risks: REITs are a creature of the tax code, and therefore have very unique tax risks. Among them are the potential tax pitfalls in structuring partners' contributions of assets to an UPREIT and transactions among the REIT and its taxable REIT subsidiaries (TRSs).

In this report we:

- Examine these risks in detail
- Frame them in a broader context, for example, succession planning as part of the broader issue of talent management
- Propose questions for boards and senior management to consider in addressing each of these risks
- Offer suggestions for REITs in how to approach these risks, by creating and implementing plans to assess and mitigate them

Succession planning for today's CEO

Many REITs have grown from their entrepreneurial beginnings into large, complex organizations. Today the job of a REIT CEO is much more demanding and requires a broader range of skills and experience than in the past.

In this report we look at what a CEO must bring to the job, such as a strong background in capital management, the need for a REIT's board to have a formal, transparent process for selecting a CEO (rather than the informal process of some REITs) and how a REIT can best develop future leaders.

Cybersecurity

Like property owners generally, REITs have tended to focus on maintaining the physical security of their buildings, such as preventing unauthorized access or break-ins. But cyber attacks present risks beyond physical security. Our report looks at ways REITs can mitigate their risk exposure by implementing measures to address them.

Tax issues

Our report looks at the need for careful planning in a partner's property contribution to an UPREIT. Planning also is essential in REIT transactions with a TRS to avoid unintended tax consequences to the REIT and its stakeholders.

Of course, these are not the only risks that REITs face; indeed, there is an element of risk in most everything that REITs do. But by determining how to address these specific risks, REIT directors and senior executives may gain insights into how to manage risks generally. As REIT leaders are well aware, successful REITs are those that are most adept at risk management.
A REIT’s board has the ultimate responsibility for selecting the new CEO. What should they be considering as part of the selection process?

Does your company have a process for selecting a future CEO?

Is the board prepared for the selection process?

What mix of skills and experience should you expect of a future CEO?

Do you have a bench of well-qualified candidates from which to select the CEO?

Do you have a talent management program for identifying, training and developing a CEO and other leaders?

How will you induce future leaders to remain with your organization?
Succession planning takes on more immediacy for boards of US REITs as CEO turnover increases

CEO succession rates (2001–2014)

Sources: BoardEx, OneSource and EY analysis.

- As a strategic goal, and as part of its responsibility to provide risk oversight, a REIT’s board should have a process for selecting a future CEO.
- A REIT’s board puts the company at risk if it fails to develop a succession planning process, including a plan for the unexpected departure of a CEO.
- The key to sound succession planning is talent management: creating and implementing policies and programs to identify, develop and, most important, retain people who are best qualified to assume leadership of a REIT.
- Creating a strong pipeline of future leaders is essential to succession planning, but by their own admission, a number of companies lack a strong talent pipeline, according to an EY report.
- As for REITs, our research has found that about 50% of REITs do have a deep bench; however, in the remaining 50% the bench is relatively thin.
- With a strong bench, a REIT has the flexibility to develop leaders internally and, if it chooses, to recruit from outside the organization. When the time for succession comes, the REIT is ready.

CEO’s role

Twenty or more years ago succession planning wasn’t a top concern of REITs. They were mostly small companies led by CEOs experienced in developing or buying and selling properties, the core businesses of REITs. At the time, that experience usually was sufficient.

Not anymore. While there are still small REITs in the industry, many have scaled up to large, complex organizations encompassing many departments and operations beyond development and transactions. The CEO’s role is strategic, with the CEO providing leadership not only in development and transactions but also across many other areas such as equity and debt finance, risk management or human resources. Furthermore, as the leader of a public company, the CEO must have a thorough understanding of REITs as an investment and the growing role of REITs in investment portfolios. While it’s not required that a CEO have experience in the same sector as the REIT, such as apartment or retail, it could add to the CEO’s credibility with the REIT’s board and investors. Externally, the CEO is on the public stage, serving as the principal spokesperson for the organization, the face of the company in dealing with shareholders and many other constituencies, and a thought leader in the real estate industry and the REIT’s sector.

Capital management

Of particular importance to a REIT’s future is the CEO’s ability to manage capital, which includes:

- Directing the REIT in raising capital in the equity and debt markets
- Making the big strategic decisions about investing millions of dollars in property development and acquisitions
- Allocating capital for investments, debt retirement and other purposes
- Paying shareholder dividends under the stringent REIT distribution rules

As we noted in our 2013 REIT report, capital allocation is one of the four pillars of a REIT’s long-term success in a capital-intensive industry. To a considerable degree, the CEO’s strategic decisions about capital allocation will determine how well the REIT performs under the CEO’s leadership.

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2 Defined as five or more senior executives (not including the CEO), each with more than ten years of experience at the organization.
Timothy J. Naughton joined what is now AvalonBay Communities, Inc., in 1989. Today, he’s Chairman, CEO, and President of the company, which develops, acquires, owns and manages apartment communities in high-barrier-to-entry markets in the Northeast and Mid-Atlantic and on the West Coast. It has a portfolio of nearly 83,000 apartment homes in 283 apartment communities and a market capitalization of US$23 billion. In an interview, he talked about succession planning, talent management and his experience with the company.

CEO perspective:
Interview with Timothy J. Naughton, CEO of AvalonBay Communities.

**Q** How did you become CEO?
**A** When Bryce Blair, our previous CEO, retired at the end of 2011 after 10 years on the job, I was the only internal candidate to succeed him. But the board went through a formal selection process, even bringing in a consultant to assist.

**Q** What was the value in that process?
**A** It was important to me because I had the opportunity to renegotiate my relationship with the board. They went on record as seeing me as the right person for the job, given the challenges facing our company.

**Q** What are your challenges as a CEO?
**A** Avalon has grown into a large, complex business. It requires a breadth of experience and skills to manage a company with different strategic groups like development, asset management and capital markets, as well as various sectors like risk management, shared services, IT, HR and others.

**Q** How do you accomplish that?
**A** By designing and developing a business model that enables the company to achieve its strategic goals, such as leveraging the advantages of scale, capitalizing on opportunities to raise and invest capital, and attracting, developing and retaining top talent.

**Q** Of the many skills required of a REIT CEO, which ones stand out?
**A** Given the substantial capital needs of a large REIT, the CEO must have skills in raising and allocating capital. These skills are so important that the CEO should come from the investment or capital side of the balance sheet – it’s a prerequisite of leadership.

**Q** Should a CEO have experience in the sector in which the REIT operates, such as apartment or retail?
**A** While same-sector experience isn’t mandatory, it is preferred. You have to be confident – and the board has to be confident in you – as you make big bets in investing money in a cyclical business. You get more support from the board if you have same-sector experience.

**Q** What is Avalon’s succession plan?
**A** Avalon doesn’t have a formal plan. Rather, we have a robust process of talent management, focused on preparing people to move up to senior leadership positions in the company. As a result, we have one of the strongest benches in the industry.

**Q** How do you prepare a future CEO to take over?
**A** You can’t predict what skills will be required of a CEO 5 or 10 years from now. What you can do is develop people who show they are the best qualified to lead this company in the future.
**Breadth of experience**

Although usually coming from a senior position in development, asset management, finance or other sector, the CEO has the breadth of knowledge and experience, and the drive and ambition, to lead not only a part of the business but also the entire organization. To that end, prospective leaders are given exposure to every aspect of the business through a REIT’s talent management program.

**Planning process**

**Board’s responsibility**

A REIT’s board has ultimate responsibility for the company’s succession planning and development of a robust leadership pipeline. Succession planning provides an opportunity for the board, along with the REIT’s senior executives, to evaluate the organization’s strategic challenges, consider future leadership needs and institute or improve leadership training. While a CEO can offer suggestions on planning, and assistance in areas such as talent evaluation and development, the board leads the planning process.

In planning, the board considers its own preparedness. Does it have the requisite information and knowledge to plan a succession and make a well-informed decision in selecting a CEO?

For assistance with succession planning, the board could reach out to specialists in the field. Consultants could have a role to play, for example, in helping to define the skill set of a CEO or designing a process for assessing internal as well as external candidates, or acting as intermediaries between the board and leadership candidates.

**Need for formal process**

REIT boards usually recruit CEOs internally in what sometimes is an informal selection process. The board has settled on the best candidate well before the new CEO takes over and, when the time comes, succession is simply a matter of executing on the details, such as creating a timeline for succession. The problem is that this approach is insufficient and could even be counterproductive to the new CEO, as it could expose him or her to questions from the board, shareholders and even the media, concerning his or her fitness and preparation for the role.

Rather, the board should have a formal, transparent selection process. It should go on record in explaining the process as well as the skills, experience and other attributes it requires in a CEO, and why the new CEO is best qualified for the position. Transparency can help the board win buy-in for its selection from the market, publicly demonstrate the board’s commitment to the new CEO and help give the CEO the confidence to hit the ground running from day one.

**Communication**

In Major League Baseball, teams promote and publicize their star minor league players. By the time these players move up to the major leagues, they’re already well known to fans. The same approach applies in readying the market for a CEO succession. A REIT helps prospective leaders get known inside and outside the organization through introductions, meetings, networking and much more, and through promotions that publicly recognize their talents and accomplishments. “Promotions of potential leaders should be highly visible, not only inside but outside of the organization,” said Serena Wolfe, a partner in EY’s New York office. “By the time they move into the executive ranks they should be well known in the market.”

**Risks**

Succession usually is an orderly process, with the board announcing the new CEO from three months to as much as one year in advance, depending upon various considerations such as timing the announcement so as not to undermine the outgoing CEO. But life is unpredictable, and the REIT is at risk if the current CEO unexpectedly departs or is terminated. If the board is not ready to name a new CEO, the REIT might suffer from the absence of leadership, such as a loss of investor confidence in the company, a fall in its share price, or difficulty in raising capital.

As part of its succession planning, the board therefore should have a plan for hiring an interim or permanent CEO from inside or outside the organization if the current CEO suddenly leaves. If there is no viable candidate, the board might select one of its members as a CEO. In any event, the plan should include a process for communicating the board’s decision to the market.

Ultimately, the best preparation for succession, whether planned or unexpected, is to maintain a robust and extensive talent management process.

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Talent management

Succession planning is part of the broader process of talent management, which is a board responsibility. The board, working with senior management, develops programs to identify, train, mentor, encourage, develop and promote future leaders; helps them gain management experience; and creates long-term compensation and incentive programs to reward and retain them.

As with performance reviews of the current CEO and other leaders, the board should have a system for rigorous reviews of leadership candidates, based on clearly defined criteria such as a prospect’s critical thinking skills or emotional intelligence, and for weeding out prospects who have shown they are not qualified for senior leadership.

Leadership training

In their leadership training, future leaders are given opportunities to advance beyond their specialties in development, transactions, finance or other areas and into senior positions in the company. These prospects are:

- Given exposure to every aspect of a REIT’s operations, including strategic planning, investment planning, property development, asset management, finance, human resources, shared services, information technology and more.

- Expected to demonstrate a deep understanding of the real estate cycle, the behavior of market players, equity and debt financing strategies, how to evaluate investment opportunities, realizing advantages of scale, proper balance sheet management, capital allocation and much more.

- Encouraged to demonstrate leadership by thinking strategically, dealing with ambiguity and uncertainty, leading teams, collaborating with other teams, and learning to make better decisions and achieve better outcomes.

- Invited to participate in a REIT’s various committees and groups, such as the Investment Committee or Executive Committee, to join in quarterly calls with analysts and others, and perhaps to attend meetings of the board.

Relationship building

Prospective leaders are expected to develop professional networks and business relationships through industry trade associations, professional groups and other organizations; to participate in an organization’s activities; to take on leadership roles; to become thought leaders in real estate and business; and, as CEO, to be the principal spokesperson for the REIT. They are encouraged to develop personal relationships with a board's directors, and to build connections with the REIT’s constituencies, including shareholders, lenders, investment bankers, the media and others.

Promoting to leadership positions

A REIT should be a meritocracy, with candidates for leadership positions evaluated based on clearly defined and transparent standards, and all candidates given equal consideration. More than that, prospective leaders need to see that they are part of a growing organization, one that will offer more opportunities for advancement, and that they are part of a culture that promotes personal initiative, encourages teamwork and collaboration, and recognizes and rewards accomplishments.

Finding future CEOs

It remains to be seen whether REITs, following the example of COO hiring, will recruit more CEOs from outside. But against that possibility, a board’s process for CEO selection should include identifying, evaluating and perhaps recruiting external candidates.

Outlook

A challenge of succession planning is that it’s a long-term process. It begins years before a CEO or other leader is appointed and its effectiveness is only known after a CEO has had time and opportunity to work in the top job. No CEO is perfect, and a well-planned succession cannot guarantee that a CEO will succeed. But it can help ensure that the best-qualified person is selected. And with the possibility of more CEO changes to come, succession planning is even more important today.
US REITs: succession planning trends

Of the 108 publicly listed REITs in excess of US$2 billion, we found the following:

Over the last 15 years, REIT CEO turnover has averaged 5.5% per annum against 10.7% for the broader S&P 500.

<table>
<thead>
<tr>
<th>REIT CEO turnover since 2000</th>
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<tbody>
<tr>
<td>30% Served five years or less</td>
</tr>
<tr>
<td>41% Served 5-15 years</td>
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<tr>
<td>29% Served 15 years or more</td>
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CEO tenure of current incumbants

<table>
<thead>
<tr>
<th>Years in role</th>
<th>% of REIT CEOs</th>
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<tbody>
<tr>
<td>10 or more</td>
<td>37%</td>
</tr>
<tr>
<td>20 or more</td>
<td>14%</td>
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On average, departing REIT CEOs served 11 years in the role.
There are currently 40 REIT CEOs that have served 10 years or more.

Internal vs. external

74% of REIT CEOs were internal appointments.
50% of REITs have a sizeable bench of experienced senior executives.

Note: We mapped CEOs from 2000-present.
Sources: BoardEx, OneSource and EY analysis.
Cybersecurity
With proper planning, REITs can mitigate risks of cyber attacks and costly consequences of security breaches

- Like every other business, REITs face increasing exposure to harmful cyber attacks.
- In addition to their corporate systems and networks, REITs must protect property-specific systems, such as building management, security and environmental systems.
- Cybersecurity should be incorporated into the REIT’s corporate governance and overall risk management policies and procedures.
- REITs can defend against and respond to attacks by implementing cyber risk management plans that have strong direction and support from the REIT’s senior management.
- Everyone in a REIT’s organization, from top executives to the newest employees, should receive education and training in cybersecurity. The better the training, the stronger the security.

Cyber preparedness is key

Cybersecurity is now front and center as a business concern – so much so that auditors now consider their clients’ cybersecurity risk in their audits. In a recent report, the Center for Audit Quality said that while an auditor’s responsibilities do not encompass an evaluation of cybersecurity risks across a company’s entire IT system, the auditor is required to understand a company’s IT systems and controls in assessing the risks of material misstatements to the financial statement. This includes an assessment of IT risks resulting from unauthorized access, evaluating a company’s accounting for cyber-related losses and assessing the impact of such losses on a company’s financial statements and disclosures. It’s clear that cybersecurity as a risk is taken seriously.

When it comes to building security, however, REITs – like property owners generally – have tended to focus on what they know best: protecting their buildings from unauthorized access, break-ins, property thefts, vandalism and other physical attacks. In the process, they have sometimes overlooked or underestimated the risks of cyber attacks. These attacks can:

- Disrupt or disable building operations and compromise building security, threatening the safety of occupants and the habitability of the building
- Result in the theft of the business plans, intellectual property and other proprietary information held by REITs, such as confidential valuations of properties
- Reveal business, personal and financial information of REITs and their tenants, such as credit reports or credit card information
- Uncover information intended to remain private, such as the identities of businesses or government agencies that do not want to disclose they are tenants in a REIT’s building, or the identities of wealthy people, celebrities and others in REIT-owned residential buildings
- Result in ransomware or an attacker’s shutting down a building’s operating system or environmental management systems and preventing the owner or manager from rebooting until the attacker is paid

Challenges in fighting attacks

Over the last two years, REITs are starting to pay more attention to cybersecurity, as people, things and organizations become increasingly interconnected, cyber attacks against US businesses continue to increase in number and scale, and the business costs of defending against and responding to such attacks continue to rise.

Where to begin? What to focus on first? How much is enough?

For REITs, some of the tactical challenges are in:

- Developing and implementing plans, policies and procedures to identify, assess and prioritize threats
- Investing in the people and technology to defend against attacks
- Preparing to respond to successful attacks
- Diligent monitoring of building infrastructures and systems to deter attacks
- Ensuring that third-party providers of building services and supplies have sufficient cybersecurity plans and procedures

Types of attacks

Whether REITs’ properties are managed internally or by third-party management companies, they are vulnerable to cyber attacks that can be carried out in many different ways. These include attacks on:

Communication systems
An attacker might hijack a building’s computer, phone and other communication systems, for example, by tapping into the phone network and recording conversations, or hacking the email accounts of REIT executives to learn about negotiations to buy or sell properties or other sensitive information. Employee emails might also be hacked to send fraudulent messages internally or externally, to a REIT’s clients, for the purposes of getting money or access to confidential information.

Building environmental monitoring systems and building management systems
Attackers could take over a building’s heating and cooling system, raising the temperature to create an intolerable work environment; disrupt temperature-sensitive computers and IT equipment; or take over the building’s emergency system, intentionally setting off false alarms and causing other disruptions.

Building security systems
Attacks could compromise the security system, enabling attackers to learn building passwords or otherwise gain access to a building.

Networks
A REIT may employ a third-party property manager to operate the building management systems, not for a single building but for the REIT’s entire network of properties. An attack on the property manager could expose the whole network to intrusion and disruption.

Data storage
REITs are creating, using, storing and sharing more data than ever. As the volume of REIT’s data increases, so too does the risk of data being exposed to attacks.

Vendors
REITs use vendors to provide a variety of services. Attackers might gain access to a building’s management system through a cleaning contractor, a provider of building supplies, a business that maintains the building’s electrical, HVAC and other systems, and other service providers.

What REITs can do

Completely stopping cyber attacks and breaches is impossible, but REITs can reduce the threat of harmful attacks by:

- **Evaluating their risks**
  “A REIT’s leadership should have a robust discussion as to what the company does, what it knows and what it owns that others might want,” said Nirvik Nandy, Executive Director, Information Technology Advisory at Ernst & Young LLP. “What information could others get that might harm the company?” Then the REIT can determine how best to protect its most valuable information and what help it might need with this process. Among the risks to consider: operations disruption risks, brand reputation, IT/trade secrets disclosure, and disclosure of confidential or regulated data, such as personally identifiable information.

- **Creating and implementing a risk assessment and mitigation plan**
  “To get the most value from their investments in cybersecurity, REITs need to prioritize their risks,” said Reza Chapman, Senior Manager, Advisory Services, Ernst & Young LLP. “Some companies are spending money without giving sufficient thought to risk management – they don’t match their spending to the level of risk.” These companies spend too much addressing lesser threats and not enough on the most serious threats. The assessment should encompass the extended enterprise, including information the REIT has in its corporate and building operating and management systems, in the cloud, on mobile devices and on social networks.
Incorporating cybersecurity risk assessment and planning into a REIT’s overall corporate governance and risk management

Because of the increasing frequency of cyber attacks, strong board oversight of cyber risk management is critical to ensuring that companies are taking adequate steps to prevent, and prepare for, the harm that can result from such attacks.6

Oversight often lies with the full board or its audit committee. But board and committee members may not have sufficient knowledge of cybersecurity to evaluate whether management is effectively addressing cybersecurity issues. Among possible solutions, the board might bring in a director with deep understanding of such issues or it could create a separate risk management committee of members conversant in cybersecurity.7

Creating, testing and implementing a cyber-incident response plan in the event of an attack

The plan must enable a REIT to respond immediately to a cyber attack: the longer it delays, the greater the risk of harm to its business. The plan should include a methodology for assessing risks; prioritizing what information, systems and networks to protect based on their value to the company; it should provide scenarios for responding to different types of attacks and incorporate a rapid response mechanism.

In the event of a successful attack, a REIT must have a process for deciding what to disclose according to regulatory or accounting guidelines and standards — including the disclosure guidelines of the Securities and Exchange Commission.8

To be sure, a REIT might not know an attack has occurred if the attackers succeed with a stealth attack. “You may never realize, for example, that a competitor has information about you as the result of an attack,” said Nandy. This is all the more reason for REITs to invest in the best possible systems and the people with the right skills to detect, defend against and deal with attacks.

Establishing a plan for disclosure of an attack

The plan guides a REIT in deciding whether disclosure of an attack is necessary based on regulatory, accounting or other standards and guidelines, and, if so, what information to provide to shareholders, regulators, auditors and others.

Educating and training everyone in the organization, from senior executives to the newest employee, in cybersecurity

Cybersecurity is a business problem, not just an IT problem. A REIT should have policies and programs for educating and training everyone in the organization in cybersecurity, including protection of passwords, protecting laptops, phones and other devices from losses or theft, securing files, preventing data losses and other security measures, and protecting against attacks through outside vendors. Training should also include how to detect internal threats such as an employee trying to steal proprietary information or sabotage computer systems. Training might be conducted by an internal IT staff or an outside vendor.

Making the right investments to establish effective security

REITs need to consider how to make the best investments in controls and technology, and in people and processes, to have the strongest possible security. They may consider selectively outsourcing or co-sourcing security programs and operations in some areas.

Outlook

REITs can’t stop cyber attacks; however, they can develop plans to defend against them. With the leadership of their boards and senior management, REITs can mitigate the risks of such attacks and the costly consequences of security breaches.

7 For guidance, boards have the Framework for Improving Critical Infrastructure Cybersecurity, released by the National Institute of Standards and Technology in February 2014 and updated in December 2014. It’s intended to provide companies with a set of industry standards and leading practices for managing their cybersecurity risks.
Questions for REITs to consider in asset contribution and tax protection agreements

Following are several questions for a REIT to consider in evaluating the risks of entering into asset contribution and tax protection agreements with an owner.

Do you have a system for conducting due diligence before entering into such agreements?

Are the terms of these agreements clear, explicit and complete?

Do you clearly understand the terms?

Are you satisfied that the owner understands the terms?

Do you understand the broader implications of a tax protection agreement, such as how you and the owner will address state and local taxes?

Do you have a system for monitoring the operating partnership (OP) not just for the duration of the tax protection agreement but also for the entire time the OP owns the asset?
UPREITs face potential pitfalls in partners’ asset contribution and tax protection agreements

- A strategy of property owners is to contribute assets to an umbrella partnership real estate investment trust’s, or UPREIT’s, OP to defer what could be a substantial tax liability.
- REITs benefit by being able to acquire properties that owners otherwise might not be willing to sell.
- Asset contributions require careful planning if owners and REITs are to avoid tax pitfalls.

Created in the early 1990s, the UPREIT is credited with boosting the modern era of US REITs. In an UPREIT, a REIT forms an OP to hold the assets of the REIT, and property owners can contribute assets to the OP in exchange for units in the OP. The REIT is the general partner of the OP and typically owns 70% to as much as 99% of the partnership’s units. Many REITs are now structured as UPREITs.

Today, owners seeking a strategy to defer a potentially substantial tax liability from disposing of assets can contribute the assets to an UPREIT’s OP. In addition to deferring taxes, owners can spread their risks by owning interests in the OP’s entire portfolio of assets rather than owning a much smaller number of properties outright. Furthermore, they can earn a return on the pretax (not after tax) value of the assets. For their part, REITs are able to acquire properties that owners might otherwise be unwilling to sell.

Assets that owners contribute to OPs may have a low tax basis and have substantially appreciated in value. Owners may want to defer recognizing the built-in gain from disposing of these assets for an extended period of time, or even until they die. At that point, the assets often get a tax-free step-up in tax basis, and accordingly, their heirs may not have to recognize taxable gain from the subsequent disposition of the inherited property.

Risks

“The asset contribution strategy can work to the mutual benefit of owners and REITs,” said John Cullins, EY’s Americas Real Estate, Hospitality and Construction Tax Leader. “However, it requires careful planning if the parties are to avoid pitfalls that could trigger unexpected and perhaps substantial tax liabilities.” Because asset contributions to UPREITs have existed for many years, REITs have gathered significant experience about the risks inherent in certain of these structures — and how to mitigate them.

“With recent valuation increases in real property coupled with higher tax rates, we are seeing more asset contribution activity than we have in quite some time,” stated Cullins. So if you are planning asset contribution transactions, careful consideration of the lessons learned is important when structuring tax OP unit transactions.

Tax protection agreements

To induce owners to dispose of their properties, a REIT may enter into what is known as a tax protection agreement. This means the REIT agrees that it will not, for a specified period of time, take any action that would trigger a taxable gain related to the contributed assets.

Furthermore, the REIT may agree to maintain a certain level of debt on contributed properties or at the OP itself for the duration of the tax protection agreement. The purpose is to allow sufficient debt allocations to the contributing partners so they can avoid triggering their built-in gain.
How it works

Assume a property owner contributes a property to an UPREIT’s OP and enters into a tax protection agreement with the UPREIT. Assume the target property has a current fair value of US$100 million and is subject to mortgage debt of US$80 million. The target property has a net tax basis of US$60 million. Thus, if the owner sold the property in a taxable sale, it would trigger a taxable gain of US$40 million. Also assume that the composite federal and state tax rate on the taxable gain is 30%, yielding a tax liability of US$12 million, and net after-tax proceeds that can be reinvested of only US$8 million.

If the property owner instead contributes the target property subject to the existing debt to an UPREIT’s OP, the owner would receive US$20 million of OP units, and if properly structured, would not trigger any current taxable gain. Thus, the property owner defers the tax-related to the built-in gain on the property and can earn a return on the US$20 million pretax net equity related to the property.

As a part of the contribution, the OP and the property owner may enter into a tax protection agreement for a specified term, whereby the OP would agree to reimburse the property owner for its federal, state and local taxes if the OP disposes of the property in a taxable sale during the duration of the tax protection agreement. Furthermore, the tax protection agreement may require a “gross-up” payment whereby the OP would also reimburse the property owner for the “tax on the tax protection payment.” This can cause the tax protection agreement payment to be substantially higher than the nominal tax rate, and can often trigger a payment in excess of 60% of the taxable gain triggered from the taxable disposition of the contributed property.

Potential pitfalls

Owners and UPREITs need to be aware of the potential pitfalls in their agreeing for the owner to contribute assets to an UPREIT’s OP and for the UPREIT to provide a tax protection agreement.

Risks to property owners and UPREITs

Among the risks to property owners and UPREITs are:

- That they enter into contribution and tax protection agreements whose terms are not sufficiently explicit
- That they do not clearly understand the terms of the agreement
- That they do not understand the broader implications of the agreement

Tax election

Under section 704(c) of the International Revenue Code, there are three alternative tax methods that address the tax treatment of the built-in gain of property contributed to the OP. Each method has particular consequences not only for the contributing partner but the OP’s other partners and the REIT itself. All the parties must understand the implications of the section 704(c) method that will be used with respect to a contributed property.

UPREIT issues

REITs must distribute 90% of their taxable income to their shareholders, and in practice, virtually all REITs distribute 100% of their taxable income. In this context, they have to consider such issues as:

- The difference between the fair value and tax basis of contributed assets
- Ongoing depreciation and taxable gain
- Distribution policies
- Leverage policies
- Amounts and types of debt
- Debt allocation
State and local taxes
Determining how to handle state and local taxes emphasizes the need for clarity in tax protection agreements. Such agreements need to specify whether a REIT will reimburse a partner or indemnify the partner for tax protection based on:

- Where the contributor lived when the property was contributed
- Where the contributor lived when the gain was triggered
- Where the REIT is located, or
- Where the property is located

If the REIT and the partners do not give enough attention to this question, the result can be ambiguities in the tax protection agreement that create tensions and result in disagreements as to how the agreement should be interpreted.

Another pitfall
An issue that at times is overlooked is the state taxation of an UPREITs’ partners in the OP and the related state tax withholding. If a REIT owns properties in multiple states, as most UPREITs do, the impact on the taxation of partners could vary from state to state.

For instance, an OP is often required to withhold and remit to a state the taxes of partners who are not residents of that state. If a REIT, as general partner of the OP, fails to do so, it may be liable to remit the required withholding to such state.

Be prepared
The underlying message for REITs in all this is to be prepared. As with any agreement, a REIT should conduct its due diligence before entering into asset contribution or tax protection agreements with partners. This includes rigorous modeling exercises that help the REIT fully understand the economic, tax, legal and other consequences of these agreements. It also includes continued monitoring of the REIT and its OP to anticipate the effects of changes such as the contribution of additional assets to an OP.

With foresight, a REIT can anticipate and avoid pitfalls that otherwise are only seen in hindsight.
Questions for REITs to consider in TRS transactions

Do you have a system for conducting due diligence before entering into transactions with a taxable REIT subsidiary (TRS)?

Do you have a clear understanding of the risks in such transactions, including improper allocations of income and deductions?

In structuring transactions, such as leases, loans or cost allocations, do you have policies and procedures to minimize the risks of IRS penalties for improper allocations?
REITs must carefully structure transactions with taxable REIT subsidiaries to reduce the risk of tax penalties

- Tax law imposes a 100% excise tax on improper allocations of income and deductions between a REIT and its TRS.
- The IRS looks to the transfer pricing rules to determine whether allocations of income and deductions between a REIT and a TRS should be respected.
- The current IRS focus is on leasing arrangements between a REIT and its TRS, but can apply to other transactions, such as loans or cost allocations.

The Internal Revenue Service (IRS) is continuing to audit REITs and their TRSs for improper allocations of income and deductions, with a current focus on leasing transactions, including those between hospitality REITs and their TRSs.

A TRS is a corporation that is owned by the REIT (directly or indirectly through an operating partnership) and makes a joint election to be treated as a taxable subsidiary of the REIT. A TRS generally may engage in any kind of business activity other than directly or indirectly managing a lodging facility or health care facility. While a REIT can provide its tenants with services customary in the rental of property, such as lighting or heating, it has to provide other, or non-customary, services through a TRS or independent contractor.

Tax law prohibits a REIT and its TRS from improper allocations of deductions to its TRS, thereby enabling the TRS to reduce its taxable income or report a net operating loss. The law also prohibits a TRS from improperly allocating income to the REIT to shield that income from corporate tax at the TRS. If it is determined that these improper allocations exist, a REIT will be assessed a 100% excise tax on the amount of the improper allocation. Depending on the circumstances, a REIT’s penalty could be in the tens of millions of dollars.

In the hospitality and health care sectors, a REIT typically owns the real estate and leases it to its TRS, which will then engage a third-party management company to manage and operate the property. The lease between the REIT and the TRS is often structured as a participating lease based on the gross revenues of the property. In a participating lease structure, the TRS typically pays the REIT a base rent plus a percentage of the property’s gross income.

The IRS has been examining the transactions of some hotel and health care REITs and their TRSs to determine whether the rents are at arm’s-length amounts. To the extent that the IRS determines that the rents are not at arm’s-length, based on the transfer pricing regulations, the 100% excise tax is imposed.

While the IRS focus has primarily been on the hotel sector, there is a cautionary tale in this for all REITs. Pay close attention to the structuring of transactions between a REIT and its TRS to avoid the 100% excise tax on improper allocations of income and deductions.
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