The Structuring and Use of Equity Participations by Real Estate Investment Trusts

W. Reeder Glass

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THE STRUCTURING AND USE OF EQUITY PARTICIPATIONS BY REAL ESTATE INVESTMENT TRUSTS

W. REEDER GLASS*

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I. INTRODUCTION

Innovation is a key to contemporary real estate financing. One of those innovations centers around the increased interest in equity participations1 by mortgage oriented Real Estate Investment Trusts (REITs).2 The reasons for this type of innovation are varied but result primarily from inflationary trends, risk factors and the novelty of the project or security for the investment. These factors lead to a desire on the part of REITs to obtain a somewhat more contingent return on their investments which will insure the desired yield.

This article will discuss some of the legal and business aspects of negotiating and structuring equity kickers with emphasis upon compliance with the provisions of sections 856-58 of the Internal Revenue Code3 and

* Member of the Florida Bar; Partner, Swann & Glass, Coral Gables, Florida. The author acknowledges the assistance of Rodney W. Bryson, Editorial Board Member, University of Miami Law Review.

1. There does not appear to be a uniform definition of these interests nor are they called the same thing by persons within the real estate industry. They are sometimes referred to as equity participations, equity kickers, equity sweeteners, etc. For a REIT, the use of the word “equity” is unfortunate in light of the stringent income and activity tests with which it must comply. A better description might be contingent interest or contingent rental. However, for ease of recognition, the type of interest discussed will hereinafter generally be referred to as an equity kicker.

2. Although there are many variations of REITs, they generally fall into three types: (a) equity trusts which invest in equity interests in real property and derive most of their income from rentals; (b) mortgage trusts which invest in mortgages on real property and derive most of their income from interest; and (c) combination or mixed trusts which engage in both types of investment. Unless the context indicates otherwise, this article will concentrate on the structuring and use of equity kickers by mortgage oriented trusts. The terms REIT and trust are used interchangeably herein. For a general discussion of equity trusts, see Rabinowitz, Real Estate Investment Trusts: Tax Problems of Equity Trusts, N.Y.U. 31ST INST. ON FED. TAX. 1773 (1973).

3. All reference hereinafter to the Internal Revenue Code or the Code will be to the Internal Revenue Code of 1954, as amended.
the applicable treasury regulations. In addition, specific types of equity kickers will be discussed with some of the business and legal problems each presents.

Several caveats are in order. Extreme care must be exercised in applying general statements regarding a particular type of equity kicker to a specific transaction. Since all relevant facts must be considered in reaching a given conclusion and these facts change from transaction to transaction, it must not be assumed in all cases that a particular type of equity kicker will be treated identically. This article will hopefully demonstrate that too simplistic an approach to a REIT’s use of equity kickers can cause serious problems which result from the failure to comply with the stringent rules under which REITs operate.

Secondly, the authority for many of the conclusions and opinions herein is based on private rulings of the Internal Revenue Service,\(^4\) commentaries and articles in this area, plus seemingly analogous revenue rulings and decisions in other areas of the tax law. Few guidelines are given by the regulations and published rulings in this area. It is important, therefore, to be conservative when negotiating and structuring equity kickers, balancing in all cases, the desire to obtain the best business arrangement for the trust without assuming an unacceptable level of business risk.

Thus, it might be said that the primary goals of a REIT in negotiating and structuring an equity kicker are: (a) to increase the yield on the mortgage investment to a level which accurately represents the risks, as well as to capitalize on the growth features of real estate and real estate oriented borrowers; (b) to obtain the type of equity kicker most likely to achieve these goals; and (c) to insure that the equity kicker will comply with the income, assets and passivity requirements of the Code, as well as with state law.

II. REIT Operational Framework

A. Current Regulations

REITs provide the small investor with the opportunity to pool his money in large real estate ventures and to achieve wide diversification and concomitantly reduced risk.

This secures for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities and mortgages directly and, therefore, equates their treatment with that accorded investors in regulated investment companies.

\[\ldots\] In both cases the methods of interest constitute pooling arrangements whereby small investors can secure advantages

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\(^4\) Private rulings are based on specific transactions and it is risky to generalize from one fact pattern to another unless they are identical. In addition, only the taxpayer who received the ruling is entitled to rely thereon.
normally available only to those with larger resources. These advantages reward spreading the risk of loss by the greater diversification of investment which can be secured through the pooling arrangement; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which investors could not undertake singly. . . . Your Committee believes it is also desirable to remove taxation to the extent possible as a factor in determining the relative size of investment in stock and securities on the one hand and real estate equities on the other. 6

To the extent that the REIT meets certain stringent requirements, the small investor receives the same tax treatment as if he held real estate equities or mortgages directly. Thus, he receives treatment similar to that accorded investors in regulated investment companies. 6

Congress intended to use the REIT as an entity to draw small investors' capital into the real estate development market. 7 The REIT was not created to afford small investors an opportunity to compete with those who actively develop real estate. Hence, Congress demanded that REITs remain completely passive in nature, 8 and not hold any property for sale to customers in the ordinary course of trade or business.

The management of a REIT's affairs is by one or more trustees. 9 Beneficial ownership is evidenced by transferable shares of beneficial interest which must be held by 100 or more persons during at least 335 days of a full taxable year, or during a proportionate part of a short taxable year. 10 Through these requirements, the REIT brings its investors together in a business venture, divides the income, and has continuity of life, centralized management, limited liability and transferability of interest.

While the above requirements are relatively easily satisfied, the Internal Revenue Code imposes certain income and asset requirements upon REITs that are not so easily met. At least 75% of a REIT's gross income must be derived from rents from real property, interest on obliga-

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20. Treas. Reg. § 1.857-1(b) (1962). Thus, dividends paid to beneficial shareholders would have to be included in Real Estate Investment Trust taxable income and tax would have to be paid thereon at standard corporate rates.
21. National REITs may pay as much as $20,000,000 or more during the year as dividend distributions. An extra tax at corporate rates on $20,000,000 would be disastrous even for the largest REIT.
relating to specific equity kickers are discussed in section V of this article.\textsuperscript{22}

B. Proposed Regulations

Recently the Service proposed several significant amendments to the regulations under section 856.\textsuperscript{23} While there are several important areas dealt with in these amendments,\textsuperscript{24} the area of significance insofar as this article is concerned relates to the treatment of interest based on net income or profits. This proposal \textsuperscript{[to amend Treas. Reg. § 1.856-2(c)(2)(ii)]} would exclude from interest under the 90\% and 75\% income tests any amount received on a debt if the determination of the amount "depends in whole or in part on the income or profits of any person." This rule would become effective for all loans made after December 7, 1972.\textsuperscript{25}

This provision is presumably designed to follow the comparable rule applicable to rents under section 856(d)(1). The National Association of Real Estate Investment Trusts (NAREIT), in a letter dated February 14, 1973, to the Commissioner of Internal Revenue, has taken the position (and quite properly so) that there is simply no statutory basis for such a rule.\textsuperscript{26}

The statutes and regulations governing REITs contain specific limitations on rental income, and the legislative history explains why.\textsuperscript{27} These same statutes, regulations and legislative history omit any similar restrictions for interest income. It is difficult to see how the regulations can be

\textsuperscript{22} It is not the purpose of this article to deal exhaustively with the intricacies of the Internal Revenue requirements by which REITs must govern their affairs. For articles dealing more extensively with this topic see, e.g., Klein, \textit{Tax Problems of Mortgage Investment Trusts}, The Arthur Young Co. J. 17 (Sept. 1971); Mirsky & Auerbach, \textit{REITS: Problems and Possible Solutions}, The Tax Adviser, 714 (Dec. 1972); Comment, \textit{The Real Estate Investment Trust: Legal and Economic Aspects}, 24 U. MIAMI L. REV. 155 (1969).


\textsuperscript{24} For example, the proposed regulations: (a) add to examples describing circumstances under which a REIT may dispose of property without being deemed to have held such property for sale to customers in the ordinary course of business; (b) eliminate the limitation that interest income qualifies under the 70\% and 75\% income tests only if it is not usurious; (c) provide an apportionment rule for interest income secured by real and other property; (d) deal with escalation provisions, percentage rents, customary services and other matters relating primarily to rental income.

\textsuperscript{25} The proposed cutoff date of December 7, 1972, leaves a real question as to the status of pre-existing loans in which interest is based on profits. It could mean that the Service, because of its previous unpublished position to the contrary, does not intend to treat as unqualified income that interest computed as a percentage of profits or net income from loans made previous to December 7, 1972. If so, it would seem appropriate to state this position affirmatively.

\textsuperscript{26} It is readily apparent that the Service is legislating rather than regulating in proposing such a rule. If it is successful in such an effort, then undoubtedly this provision will be used to justify the application of other non-interest rules contained in the REIT sections of the Code and the regulations thereunder. The "boot strap" implications in the adoption of the rule, as proposed, are obvious.

justified by the "discovery" at this late date of any basis in the legislative history for this kind of limitation.

Furthermore, the Service is, in effect, saying that interest, for purposes of section 856, will be defined differently than for other sections of the Internal Revenue Code. It is difficult to understand the rationale for such a position, and in light of the absence of statutory authority and the existence of case authority to the contrary,28 the regulation is probably invalid. Hopefully, the Service will reconsider its proposed position and allow interest, for purposes of section 856, to be defined in a traditional manner. There certainly seem to be sufficient safeguards and controls over REITs and their income and activities without adding a tortured definition of interest.

Finally, the proposed regulation can be expected to lead to the application of other rental rules to the interest area by the Service. Not only does such a possibility add further uncertainty for a REIT and its adviser, it could require the REIT as a lender to attempt to exercise controls (such as over subtenants of its tenant-borrower) which, as a practical matter, are inappropriate.

C. Real Estate Investment Act of 1973

On October 24, 1973, several members of the Ways and Means Committee introduced H.R. 11083, entitled "Real Estate Investment Trust Act of 1973." The Bill was drafted by the staff of the Congressional Joint Committee on Internal Revenue Taxation on the basis of NAREIT proposals summarized in an explanation distributed to its members on September 29, 1972. The Bill proposes a number of changes in the present law designed to avoid the disqualification of a REIT where the failure to meet certain statutory qualification tests is inadvertent or due to circumstances presented by necessary acts of a REIT in the mortgage lending business.

For example, the Bill proposes to treat commitment fees as qualified income under the 75% income test, the elimination of the need for allocating rental income between real and personal property where the rent attributable to personal property does not exceed 15% of the total rent, treats as qualified rental income any separate charges received for customary services and permits REITs to use the corporate form. In addition, the Bill adopts the principal of taxation of non-qualified income instead of disqualification if certain conditions are met, provides for a late designation of capital gains and a deficiency dividend procedure. The Bill expands the statutory definition of interests in real property to include options to purchase such property which would have the effect of treating income from such options as qualified under the 75% income test and the

options would be treated as real estate assets under the 75% asset test. The 90% income test has been increased to 95%. In other words, non-qualified income (other than gains from the sale of inventory property) may not exceed 5% of the REIT's gross income. In the same vein, the 30% income test limiting the amount of gross income which may be derived from the sale of securities and real property held for less than four years is expanded to cover income from the sale of mortgages held for less than four years.

In the foreclosure area the Bill provides that gains from the sale of foreclosure property and income from the operation of such property, which do not meet the income tests, are taxable without disqualification consequences upon election by the REIT. The election period is limited to two years with two one-year extensions if shown to be necessary for the orderly liquidation of the property. Also, the Bill requires the REIT to install an independent contractor within 90 days of acquisition to manage the property along with several other restrictions relative to new leases.

One of the areas in the REIT Code sections which has created the greatest concern is the holding for sale provision of section 856(a)(4). The Bill changes this rule by eliminating section 856(a)(4) prohibiting a trust from holding any property for sale and allows a REIT to have up to 1% of its gross income from such sources, with the income from this source being taxed at corporate rates. Any income from such sources in excess of 1% would be subject to an additional tax rather than disqualify the REIT, provided the REIT had reasonable ground to believe that the excess income would not be determined to be from such sources.

While the Bill did not follow NAREIT's proposals in every respect, the relief provided, if adopted, will certainly eliminate some of the areas of greatest concern to REITs and their advisers.

III. CHARACTER AND SOURCE OF INCOME

To insure that equity kickers comply with the income tests set forth in the Code, a REIT must be concerned with both the character and the source of income generated by the kicker. A minimum of 75% of a REIT's gross income must be derived from real property assets; another 15% must be derived either from real property assets, dividends and interest, or gains from the sale of stock, securities or real property. Ten percent of the trust gross income is unlimited, as to character or source, except for the prohibitions against income from the active conduct of business and from holding property primarily for sale to customers in the ordinary course of its trade or business. The application of these provisions, both

29. It appears from the committee reports that some income may be derived from non-passive income sources and from the active conduct of a trade or business. H.R. REP. No.
as to character and source of income, is complex and difficult, especially in the area of equity kickers. Where an equity kicker is negotiated in conjunction with a loan transaction, the desired characterization is that of interest income, whereas if negotiated in connection with an equity investment, the desired characterization is one of rental income.  

The Code does not contain a definition of the word interest. Section 163(a), dealing with the deductibility of interest, states that “[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.” The Service has accepted a definition of interest stated as “the amount which one has contracted to pay for the use of borrowed money” and “compensation allowed by law or fixed by the parties for use, or forebearance, or detention of money.” As will be seen in the discussion of various types of equity kickers, whether the income qualifies as “interest” for purposes of section 856 of the Code is not as simple as the quoted definitions would indicate.

In addition to the consideration which must be given to the courts’ definition of interest and its application to REITs by the Service, there are other factors which are particularly relevant to equity kickers. For example, while there is no requirement that interest, to be deductible, must be reasonable in amount, excessive payments of interest have been challenged and the question raised as to whether the interest paid was in

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20. 86th Cong., 2d Sess. (1960), cited in 1960-2, CUM. BULL. 819, 822. However, the Service has taken the position, in a private ruling dated March 12, 1971, that a REIT may not engage in a service business, nor in the active conduct of any business, even though such business does not involve holding any property primarily for sale to customers in the ordinary course of a trade or business. The Service, in rendering its interpretation of congressional intent, stated:

We consider that this language (to the effect that the greater part of the income of the trust must be from passive sources) was used by Congress to show it did not intend real estate investment trusts to be disqualified by the casual or accidental receipt of types of income derived from dealing in real estate or interests therein, and not to allow such trusts to purposely engage in the active operation of a service type business.

Merritt, Primarily For Sale and Prohibited Purposes, P.L.I. REAL ESTATE INVESTMENT TRUSTS 3d, No. 41, 7 (1971). An application of the Service’s position appears in Rev. Rul. 72-353, 1972 INT. REV. BULL. No. 30, at 9, dealing with the receipt by a REIT of rental income based upon profits, which did not disqualify the REIT as long as the profits were less than 10% of its gross income. See also Memorandum from NAREIT (National Association of Real Estate Investment Trusts) to members, August 15, 1972; Shop Talk, 38 J. TAX. 199 (Sept. 1972).

30. Since the major thrust of this article relates to the structuring and use of equity kickers by mortgage trusts, the definitional and source problems relating to what is “rents from real property” will be discussed only where they are analogous to the interest area (or at least have been construed as analogous by the Service).

31. There is no requirement that interest be reasonable in amount to be deductible as there is for rent or compensation payments. See Kanter, The Interest Deduction: When and How Does It Work?, N.Y.U. 26TH INST. ON FED. TAX. 87 (1963).


fact something else, merely identified as interest for the convenience of the parties to the transaction.\textsuperscript{34} This point will be discussed further in connection with the passivity restrictions of REITs.

While the courts and Service have stated that it is unnecessary for the parties to label payments as interest in order for it to be deductible as such when it is paid for the use of borrowed money,\textsuperscript{35} both have also stated that the mere characterization placed on payments by the parties is not binding. For example, the mere fact that the parties intended to create a debtor-creditor relationship is not conclusive. In \textit{Farley Realty Corp. v. Commissioner},\textsuperscript{38} the court held that:

\begin{quote}
Just as the Commissioner may ignore the labels the parties have placed upon their relationship when these labels fail to describe the realities of the relationship, so too the parties' bona fide intentions may be ignored if the relationship the parties have created does not coincide with their intentions.\textsuperscript{37}
\end{quote}

Treasury Regulation 1.856-2(c)(2)(ii) provides that interest, for purposes of sections 856(c)(2)(B) and 856(c)(3)(D), includes "only the amount which constitutes lawful interest for the loan or forbearance of money. Thus . . . usurious or illegal interest . . . shall not be included as interest."\textsuperscript{38} The proposed regulations, if adopted in their present form, would eliminate this requirement.\textsuperscript{39}

\section*{IV. Operational Problems}

\textbf{(Holding Property Primarily For Sale to Customers in the Ordinary Course of a Trade or Business)}

A paramount consideration in negotiating and structuring equity kickers (apart from the characterization and source of the income) is whether, in the manner of computing the equity kicker or because of its structure, it can be argued that the REIT is violating the passivity and operational limitations of the Code. The principal restriction on the activ-

\textsuperscript{34} See, e.g., Knetsch v. United States, 364 U.S. 361 (1959); \textit{In re Indian Lake Estates, Inc.}, 448 F.2d 574 (5th Cir. 1971).


\textsuperscript{36} 279 F.2d 701 (2d Cir. 1960).

\textsuperscript{37} \textit{Id. at} 705, \textit{citing Central Cuba Sugar Co. v. Commissioner}, 198 F.2d 214, 217 (2d Cir.), \textit{cert. denied,} 344 U.S. 874 (1952).

\textsuperscript{38} Treas. Reg. § 1.856-2(c)(2)(ii) (1962). There is no statutory authority for the exclusion of usurious interest from the provisions of section 856. In fact, the courts have held not only that usurious interest is deductible, but that it is and continues to be taxable as such. Barker v. Magruder, 95 F.2d 122 (D.C. Cir. 1937); \textit{Jones Syndicate v. Commissioner}, 23 F.2d 833 (7th Cir. 1927).

\textsuperscript{39} For the problems raised by the usury problem both for state and federal tax purposes, see NAREIT memorandum to members, December 15, 1971; Comment, \textit{Usury and Real Estate Investment Trusts: An Analysis of Treasury Regulation 1.856(c)(2)(ii)}, 60 CAL. L. REV. 147 (1972); Note, \textit{Applicability of State Conflicts When Issues of State Law Arise in Federal Question Cases}, 68 HARV. L. REV. 1212 (1955).
The language of section 856(a)(4) has not been subject to judicial consideration. However, both sections 1221(1) and 1231(b)(1)(B) contain the crucial phrase “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” This language is, of course, virtually identical to the language of section 856(a)(4). Not only is the language of the two sections virtually identical, but the purposes behind sections 856(a)(4) and 1221(1) are generally comparable, to distinguish “passive investment” and “active business.” The many decisions, then, interpreting and applying section 1221(1) and 1231(b)(1)(B) will have a bearing on the interpretation of section 856(a)(4). As will be seen, the complexity of REIT transactions may mask situations in which the Service has raised the question of holding for sale under sections of the Code using the same language. The seriousness of a violation of this provision is obvious and far more consequential than the mere question of ordinary income versus capital gain. If an otherwise qualified REIT holds one property primarily for sale to customers in the ordinary course of its trade or business, it would be disqualified for the entire taxable year.

The holding for sale question is not unique to situations dealing with equity kickers but has been raised in connection with foreclosures, participations and options granted in sale leaseback transactions.

41. One of the most significant cases in recent years is Malat v. Riddeil, 383 U.S. 569 (1969), which held that the word “primarily” means “principally” or “of first importance.”
42. The consequences, to mention a few, are: (a) the cash distributions after tax would be reduced by approximately 50%; (b) a probable permanent impairment of capital by virtue of having to pay the tax in a year after at least 90% distribution of taxable income; and (c) a disastrous effect on the REIT’s stock in the public market.
43. For example, where the trust forecloses and takes title to an unfinished project, it must make arrangements, as other lenders do, for the completion and disposition of the project. If, however, it commenced an extensive effort to complete and market the houses or lots, it can be argued that this property has become inventory property held by the trust primarily for sale to customers in the ordinary course of its trade or business. See White, Mortgage Foreclosures—Tax Aspects, P.L.I. REAL ESTATE INVESTMENT TRUSTS 4th No. 66, 111-13 (1972); Agger, Tax Problems of Mortgage Real Estate Investment Trusts, N.Y.U. 31st Inst. on Fed. Tax. 1739 (1973). The proposed regulations, while not dealing with the sales of such properties in a piecemeal fashion, as opposed to bulk sales, will allow a REIT to complete structures which are above a certain percentage of completion (i.e., 80%). A difficulty with providing any safe harbours from the application of this provision is the potential spillover of such exceptions into the interpretations of other sections of the Code. H.R. 11083, discussed in section C of Article II, infra, solves this problem in part by deleting section 856(a)(4) and instead provides that gains from the sale of foreclosed property.
According to the Internal Revenue Service, the most flagrant violation of the passivity provisions is the equity kicker which seeks a share of the net profits of a borrowing entity. In these cases, the lender departs from its traditional right to receive compensation for the use of borrowed funds (i.e., an absolute right to receive interest payments irrespective of profits) and agrees to share in the risks that the borrower or any traditional investor take; that is, will there be profit and how much. This type of "risk sharing" parallels that taken by investors, stockholders and other persons who have a proprietary, as opposed to a creditor, interest in the project. By entering into such a participation, the trust is exposed to the analogy of the traditional "risk taking" investor and to the argument that what was intended (irrespective of the documentation or form of the transaction) was a joint venture, partnership or some other profit sharing arrangement whereby all the activities of the business are imputed to each equity owner. This type of arrangement also presents characterization problems (i.e., is the payment interest, dividends or a share of partnership profits).

Even those equity kickers which are computed in a manner which has received acceptance by the Service, at least in private rulings (i.e., a percentage of gross receipts or revenues), can be troublesome when structured in a manner that raises questions as to their character. For example, suppose a REIT made a three-year loan (either construction or mini-permanent) with a fixed rate of interest plus an equity kicker of 3% of gross receipts for 10 years or longer, with provision for the principal to be repaid during the normal term of the loan. Normally, a kicker computed on a percentage of gross receipts creates no problem, but by structuring the kicker to extend seven years beyond the term and repayment of the loan, a question is raised as to what the parties really bargained for. Traditionally, interest ceases at or shortly after the principal is

44. Some REITs engage in a substantial number of sales to other lenders of participations in loan programs. The Service has indicated that where the REIT commits to the entire loan and then participates it to other lenders, this could be the holding of property primarily for sale. Where, however, the REIT commits only to a portion of the loan and conditions its acceptance on the joint participation of other lenders, it has been indicated that this does not present the same problems. The proposed regulations do not deal with this problem, probably because this problem can be avoided by appropriate care in negotiating and drafting. See Grunderman and White, Mortgage Loans and Participations, P.L.I. REAL ESTATE INVESTMENT TRUSTS—PROBLEMS AND OPPORTUNITIES, No. 17, 139-43 (1973).

45. Another potential violation of section 856(a)(4) arises in connection with a common practice in sale-leaseback transactions of granting to the seller-lessee an option to repurchase the property. The question here is whether the REIT is holding the option primarily for sale to customers in the ordinary course of its trade or business. The prospectus for the Institutional Investor's Trust dated July 20, 1972, indicated that the Service has ruled that such options are not being held for sale while they are unexercisable. In all likelihood, where the option is exercisable at a price reflecting fair market value and where there are no economic factors tending to require exercise, the Service should be willing to assume that the primary purpose of the transaction was the collection of rent and that the option was merely incidental thereto. The proposed regulations do not deal with the holding of options primarily for sale. See Agger, Tax Problems of Mortgage Real Estate Investment Trusts, N.Y.U. 31ST INST. ON FED. TAX. 1739 (1973).
repaid, yet here we have payments continuing long beyond the debt itself. If the Service attempts to reclassify the character of the payment, it must find some other category in which to place the payments. If the borrowing entity is a partnership or joint venture, the Service might say that the trust has become a partner or joint venturer. If the borrower is a corporation, it might say that the trust has become a stockholder of a special class of stock. In either event, the trust and the borrower might well face litigation over the character of the payment (as well as over deductibility from the borrower's viewpoint), and the trust faces the possibility of being considered to be engaged in an active business.

The intent of the parties will normally govern the treatment of a payment as to its character and also as to the type of relationship bargained for and created, provided, of course, that the relationship created was what was intended. Since intent is a subjective matter, the courts and the Service look to less subjective criteria in order to test the stated intent. Care should be exercised to insure that all documents and conversations, as well as negotiations, are consistent with the intent. You can expect the courts and the Service to be persuaded not only by the legal documents evidencing the transaction, but also by the loan submission and letters between the trust and the borrower, as well as between their respective counsel. Serious doubt may be cast on the entire characterization and structuring of an equity kicker where the negotiations and the documents evidencing the loan speak not of interest or additional consideration for the loan, but of net profits, joint venture and other words of similar import.

In Rev. Rul. 73-398, the Service held that a REIT that sold several long-term fully funded mortgages to an unrelated mortgage broker in a single isolated transaction to correct an imbalance in its loan portfolio was not considered to be holding property primarily for sale to customers within the meaning of section 856(a)(4) of the Code. The stated purpose for the sale was to reduce investments in long-term loans and increase investments in short and intermediate-term loans thereby improving its competitive position in borrowing money. The trust represented that it had not sold any mortgages in the past and did not intend to engage in any other selling activities. Because of the limited facts, the ruling will probably not be of great benefit to other REITs except to indicate that the Service will rule favorably in the holding for sale area given certain facts and a good business reason for the sale.

V. PARTICULAR EQUITY KICKERS

A. Stock, Warrants and Convertible Interests

The Code contains two restrictions upon a REIT's acquisition of an ownership interest in another entity. One restriction relates to an asset test and the other to the qualification of rental income. Section 856(c)

(5)(B) requires, in pertinent part, that a REIT not have, at the close of any quarterly period, more than 25% of the value of its total assets represented by securities (other than government securities). Further, the REIT (within the 25% limitation) may not own securities of any one issuer of a value greater than 5% of the trust's total assets or representing more than 10% of the outstanding voting securities of such issuer. The second restriction is derived from the definition, in section 856(d) (2)(A), of "rents from real property," which excludes any amount received or accrued, directly or indirectly, from any corporation if the REIT owns, directly or indirectly, stock possessing 10% or more of the total combined voting power of all classes of stock entitled to vote or 10% or more of the total number of shares of all classes of stock. This exclusion from the definition of "rents from real property" was intended by Congress to prevent the avoidance of the passive income restrictions through the device of setting up a related corporation. The limitation in the asset test "was designed to provide diversification in any of the trust investments other than the real estate assets . . . ."\textsuperscript{47}

While all REITs must be concerned with compliance with the restricted ownership of voting securities for asset test purposes, only equity REITs or those which negotiate for a rental return on their investment need be concerned with the 10% rule relating to the definition of "rents from real property." A safe course of action, however, would be to qualify all investments under both standards so that, in the event of reclassification or subsequent mixed financing packages, the income will be qualified.

The REIT sections do not define the term "voting security" but do incorporate by reference the definition contained in the Investment Company Act of 1940.\textsuperscript{48} There, the term "voting security" is defined to mean "any security presently entitling the owner or holder thereof to vote for the election of directors of a company." The word "security" is further defined by the Act to include "any . . . stock."\textsuperscript{49}

\textsuperscript{47} H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4-5 (1960), cited in 1960-2 Cum. Bull. 819 at 822-23. The 10% voting stock restriction of section 856(c)(5)(B) appears to be ineffective to achieve the stated purpose since it has no relationship to the value of the assets of the trust. In light of the restriction, in the same section, on ownership of securities of any one issuer having a value more than 5% of the trust's total assets, it may be that the 10% restriction was designed to prevent REITs from engaging in the active conduct of a trade or business.


\textsuperscript{49} 15 U.S.C. § 80a-2(a)(36) (1970). The definition of "security" in the Investment Company Act includes many specific types of instruments such as notes, bonds, debentures, evidence of indebtedness, and a general reference to "any interest or instrument commonly known as a security" and to the "right to subscribe to or purchase, any of the foregoing." Thus, any hybrid type instrument which carries the right to vote for directors of the issuer could be subject to classification as a "voting security" under the Act. The term "securities" does not, however, include "interest in real property" or "real estate assets" as those terms are defined in section 856 of the Internal Revenue Code of 1954 and in Treas. Reg. § 1.856-3(c) (1962) as amended by T.D. 6841 (1965).
The percentage of ownership of non-voting stock is not restricted for purposes of the asset tests and REITs can acquire ownership of all or a substantial percentage of such classes of stock as equity kickers. Generally, the articles of incorporation of the borrower do not authorize or provide for the issuance of either a second class of stock which is non-voting or of non-voting shares of stock within the same class. Counsel for the REIT must, therefore, see not only that such a class of stock is authorized by appropriate modification of enabling instruments of the corporation and that the stock is validly issued, but also that the corporate laws of the state of incorporation authorize several classes of stock or distinctions within a class of stock.

Should additional rights be negotiated for the class of stock the REIT receives, such as preferences on dividend distributions and liquidation, these rights must also be specified in the articles, approved by shareholders and directors, where required, and sanctioned by the statutory or decisional law of the state of incorporation. Failure to give careful attention to such details can cause the trust's shares to be illegally or defectively issued, resulting in both state law and federal tax law problems.

The Service has taken the position that stock warrants, shareholders' voting agreements, stock options, convertible debentures and similar rights do not constitute "voting securities" for purposes of section 851(b)(4) of the Code (relating to Regulated Investment Companies). The ruling cites as authority the requirements of section 851(b)(4), which contains a 10% voting security rule similar to that contained in section 856(c)(5)(B), and the definition of "voting security" contained in the Investment Company Act of 1940. Thus, it would seem to be relatively safe for a REIT to also obtain such interests without fear of violating the percentage limitation restricting ownership of voting securities.

If, however, a trust were receiving rents from a corporation in which it owned a percentage of non-voting stock in excess of 10% of the total number of shares of all classes of stock, the rental income would not qualify as "rents from real property" and therefore would fall into the 10% basket of unqualified income. Int. Rev. Code of 1954, § 856(d)(2)(A).

In light of the restricted definition of "voting securities" in the Investment Company Act of 1940, it would seem that limited voting rights might be negotiated. Considering the risks of overstepping the statutory restrictions in the Code as interpreted by the Service (or for that matter an amendment of the Investment Company Act of 1940 expanding the definition of "voting securities"), and the limited benefits obtained from such limited voting rights, it hardly seems prudent to negotiate such rights.


Warrants or other rights to acquire stock may present particular problems in the 50. If, however, a trust were receiving rents from a corporation in which it owned a percentage of non-voting stock in excess of 10% of the total number of shares of all classes of stock, the rental income would not qualify as "rents from real property" and therefore would fall into the 10% basket of unqualified income. Int. Rev. Code of 1954, § 856(d)(2)(A).

51. In light of the restricted definition of "voting securities" in the Investment Company Act of 1940, it would seem that limited voting rights might be negotiated. Considering the risks of overstepping the statutory restrictions in the Code as interpreted by the Service (or for that matter an amendment of the Investment Company Act of 1940 expanding the definition of "voting securities"), and the limited benefits obtained from such limited voting rights, it hardly seems prudent to negotiate such rights.


54. Warrants or other rights to acquire stock may present particular problems in the
tion of warrants or convertible debentures are attractive since they allow a REIT to potentially acquire a larger percentage of voting stock of the borrower than could be obtained by immediate ownership.

From an investment point of view, stock ownership is generally not as attractive as other types of equity kickers, although in most cases, it is easier to negotiate and structure. Because of the small percentage of voting stock that a REIT can own, it can be and often is at the mercy of the majority shareholders on matters such as dividend distributions, liquidations, high risk ventures and milking tactics. More stock can potentially be obtained through warrants and convertible debentures and buy-sell agreements can be negotiated, but where more than 10% of the voting stock is acquired, it must be disposed of within the same quarter. Aside from the difficulty in marketing closely held corporation's stock in such a short time, the REIT must be careful not to hold these shares primarily for sale to customers in the ordinary course of its trade or business, nor to derive more income of this character than allowed by the 30% income test of section 856(c)(4). To counter these problems, the REIT might seek to obtain maximum rights in connection with its stock or warrants, such as preferential dividends (both in time and amount), restrictions on voting rights of the other stockholders and control of key decisions of the corporation. Care must be exercised not to create a situation where the Service could argue that such rights converted non-voting to voting stock or gave the REIT more voting power than 10% of the stock to which it is entitled.

55. If the conversion feature and other aspects of the transaction caused the note to be treated as stock under section 385 of the Code, problems could arise under the income and asset tests. It has been suggested that receipt of such convertible debentures should be deferred until regulations under that section are promulgated. While this is obviously the prudent approach, there is little probability that these regulations will be promulgated in the near future because of lessening public and congressional concern about the conglomerate movement cited as one of the reasons for the original enactment of the statute.

56. While section 856(c)(5) of the Code (last paragraph) allows elimination of certain "discrepancies" within 30 days after the quarter in which triggered or created without losing REIT status, it is doubtful that the 30 day grace period is applicable to the disposition of outstanding voting securities of an issuer in excess of the 10% limitation. The legislative history of section 856 indicates that the 30 day rule is similar to that contained in section 851(d). H.R. Rep. No. 2020, 86th Cong., 2d Sess. (1960), cited in 1960-2 Cum. Bull. 819, 825. A review of the legislative history of section 851(d) and a literal reading of section 856(c)(5) indicates that the word "discrepancy" in that section relates only to a discrepancy between the "value" of its various investments and such requirements and not all discrepancies. H.R. Rep. No. 2333, 77th Cong., 1st Sess. (1942), cited in 1942-2 Cum. Bull. 372 at 463; Treas. Reg. § 1.856-2(d)(4), example 3 (1962).

57. The 5% asset test must also be considered. Thus, stock or warrants of a single borrower plus that portion of the borrower's indebtedness deemed secured by personality cannot together exceed 5% of the trust's total assets. Int. Rev. Code of 1954, § 856(c)(5) (B).

58. For example, in Glover Packing Co. v. United States, 328 F.2d 342 (Ct. Cl. 1964), the court was faced with the question of whether certain shares were "outstanding" for
In addition to the above, consideration should be given to the following:

(1) Non-dilution rights as well as an agreement to piggyback the REIT’s shares on the first registration should be, if possible, negotiated and at no additional cost. In addition, restrictions or at least notice provisions should be required from the borrower on the redemption of stock since such a redemption could propel the trust into the ownership of more than 10% of the borrower’s outstanding voting securities.59

(2) Once stock ownership has been obtained, the REIT must be vigilant in subsequent dealings with the same borrower, affiliated corporations or major shareholders thereof, to avoid the acquisition of additional stock which, by attribution, will place the trust in the position of owning more than 10% of the voting stock or 10% or more of the combined total of all classes of stock.60

(3) Merely requiring a pledge of all the voting stock of a corporation in connection with a mortgage loan would not violate the requirements of section 856(c)(5)(B) if it is clear that the stock is transferred only as collateral. Problems can arise, however, if by the terms of the pledge the REIT acquires ownership automatically upon default. Some states require that formal and time consuming steps be taken before stock can be sold or transferred. Even if the REIT undertook to liquidate the corporation and distribute the assets, it might not be able to comply with applicable state and federal tax requirements before the end of its tax quarter. It should be clearly provided that the pledgor retains at least some voting rights61 and that the REIT’s rights, upon default, are to sell the stock to a third party on behalf of the pledgor rather than to acquire legal title to it.

(4) The receipt of stock or convertible rights thereto as an equity kicker presents valuation and characterization problems, as well as

purposes of section 382. The purchaser received only 10% of the loss corporation’s stock, the remaining shares being placed in escrow. No dividends could be paid on the escrowed shares, nor could they be sold or hypothecated, and they were subject to redemption. The court held that these shares were not “outstanding”. See Treas. Reg. § 1.957-1(b)(2) (1963).

59. Although the violation of said restrictions could subject the borrower to an action for breach of contract or damages, this will be of little consolation to the REIT which faces disqualification. The Service might be persuaded to rule, in such a case, that such a violation was not fatal. In Rev. Rul. 64-247, 1964-2 CUM. BULL. 179, the Service held that a regulated investment company was not disqualified even though it received proceeds of a lawsuit for recovery of excessive management fees which exceeded the applicable income limitations under section 851 of the Code.

60. INT. REV. CODE OF 1954, §§ 318(a)(2) and (3), incorporated by reference with modifications by INT. REV. CODE OF 1954, §§ 856(d)(2) and (3), by the last paragraph of section 856(d). See also Rev. Rul. 70-542, 1970-2 CUM. BULL. 148; Memorandum from NAREIT to members, April 25, 1972.

61. Query whether a provision under state law granting voting rights in pledged stock to the pledgee would be determined by the Service to technically violate the 10% rule? See CAT. CORP. CODE § 2218 (Deering 1962), which allows shares standing in the name of a pledgee to be voted as well as the exercise of all rights incident thereto without proof of authority.
triggering different reporting rules for income tax purposes. It is understood that private rulings have been issued holding that the stock or warrants produce original issue discount under section 1232(b) and constitute qualified interest reportable over the life of the loan. This treatment should be contrasted with loans purchased at a discount from their face amount which are treated as market discount producing no immediate income. A discussion of these rules is beyond the scope of this article, but the subject is obviously important and must be given careful consideration.62

B. Contingent Interest

(Percentage and Fixed Dollar)

A commonly used form of equity kicker bases contingent interest or rent upon either a percentage of or fixed dollar amount of the borrower's or tenant's receipts, revenues or sales (hereinafter gross income).

Some of the variations commonly used are: (1) a fixed percentage of gross income (i.e., 7% of gross income); (2) a fixed percentage of gross income or a fixed dollar amount, whichever is greater or lesser (i.e., 4% of gross income or $200,000, whichever is greater); (3) a fixed percentage of gross income over a stated dollar amount (i.e., 5% of gross income over the first $200,000 of gross income); (4) a fixed percentage of gross income with a floor and also a ceiling (i.e., 5% of gross income or $200,000, whichever is lesser with a floor of $100,000); (5) a fixed percentage of gross income based on varying percentage plus an escalator clause; (6) a fixed percentage of gross income with the computation of gross income subject to reduction for certain costs (i.e., taxes, insurance, janitorial services); and (7) varying percentages of gross income (i.e., 2% of the first $1,000,000 of gross income, 4% of gross income over $1,000,000 and less than $2,000,000).63

Some of the types of contingent interests based upon a fixed dollar amount are: (1) lot release fees; fixed dollar per unit, etc.;64 (2) prepay-
payment premiums, late charges and extension fees (which are not strictly equity kickers); 65 (3) an interest in the recreational leases of the common areas in a condominium project; (4) a dollar amount (or percentage) of the proceeds from refinancing. This can also be derived from agreeing to subordinate or in allowing a second mortgage to be placed on property (or by allowing a wrap-around). 66

The preceding lists are by no means exhaustive. The types of percentage and fixed dollar equity kickers (from a non-tax standpoint) are limited only by the nature of the project owned or being financed and the imagination of the underwriter. 67 The fixed dollar type of equity kicker is generally favored by the lender because realization can be computed and timed. Further, such kickers are less controlled by the borrower's actions, and they can be secured and are payable irrespective of whether the borrower meets his projections or makes a profit. The latter result is obviously not attractive to the borrower or tenant and may result in an attempted de-emphasis of potential appreciation, receipts or gain in order to keep the kicker amount as small as possible.

An unusual aspect of contingent interest is its relation to the principal as compared to conventional or fixed interest. Since contingent interest generally will increase as the loan amortizes, whereas conventional interest decreases, the economic consequence is contrary to the concept that interest is being paid for the use or forebearance of money. The Service has expressed some concern that contingent interest resembles a profit participation with the borrower. 68 The REIT sections already exclude penalties and since the lender has reduced its security, a higher interest rate may be justified. Additional risks may be encountered if the Service can establish that the payment was for services performed by the lender. See Memoranda from NAREIT to members, November 13, 1973.

65. General American Life Insurance Co., 25 T.C. 1265 (1956), acquiesced in 1956-2 CUM. BULL. 5; Rev. Rul. 57-198, 1957-1 CUM. BULL. 94; Memoranda from NAREIT to members, November 24, 1972, and January 7, 1972; Rev. Rul. 73-141, 1973 INT. REV. BULL. No. 12, at 9; private rulings. Although there is some authority that late charges, at least in the municipal bond area, are penalties, it is felt that those cases are distinguishable and that the better rule is that the payments qualify as interest for the 75% income test. Extension fees appear to be analogous to points or other fees charged for keeping the loan outstanding longer. Grossly disproportionate premiums, charges and fees should be avoided as they can be considered penalties as opposed to interest.

66. It would seem that receipt of a percentage or fixed dollar amount of the proceeds from refinancing, subordination or allowing a second mortgage or wrap-around mortgage to be placed on the property is income that qualifies for the 75% and 90% income tests as either interest or gain from the sale or other disposition of real property, which includes interest in real property and mortgages on real property. Other possibilities are that the payments will be treated as rental income if the REIT is subordinating its fee to additional financing; see the dictum in Rev. Rul. 70-132, 1970-1 CUM. BULL. 138; Stahl v. United States, 441 F.2d 999 (D.C. Cir. 1970); or as payments in the nature of commitment or standby fees. See, e.g., Rev. Rul. 69-455, 1969-2 CUM. BULL. 9.

67. The real point of negotiation between the lender's representatives and the borrower is not how but how much. Structuring will generally be affected, from a timing standpoint, by the cash needs and projected revenues of the borrower.

68. This attitude makes it doubly important that all documentation connected with the negotiation and documentation of the transaction, as well as that of the equity kicker, be consistent with the intent to receive contingent interest which is not merely a recomputed
from the definition of "rents from real property" any amounts—the determination of which depends on the income or profits from such property.\textsuperscript{69} While the same section states that any amount received shall not be excluded from the definition \textit{solely} by reason of its being based on a fixed percentage or percentages of receipts or sales, the regulations contain the admonition that "an amount will not qualify as 'rents from real property' if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practices but is in reality used as a means of basing the rent on income or profits."\textsuperscript{70} The same factors used in determining whether percentage rents are in effect a profit sharing arrangement may be deemed by the Service to be applicable to a REIT receiving contingent interest based on a percentage of gross revenues, even though no such statutory or regulatory limitations exist in the "interest" area.\textsuperscript{71}

In at least one private ruling, in 1970, the Service held that contingent interest equal to 50% of the borrower's net profits from the sale of the development was "interest on obligations secured by mortgages on real property" for purposes of section 856(c)(3)(B). It should be noted that there was no mention of the profit sharing arrangement.\textsuperscript{72} The proposed regulations clearly indicate that the Service has reconsidered its position, and that the same ruling could not be obtained today. A corollary to such a position would be a finding that the REIT and the borrower have, in effect, formed a joint venture or partnership which might disqualify the trust.\textsuperscript{73}
In some cases, the payment of contingent interest may extend beyond the term of repayment of the loan to which it relates. The rationale of the Service’s position could be that, without an underlying indebtedness, the payments cannot be characterized as interest. This would seem to be a very restricted interpretation of interest, more related to the time of receipt than to the substance of the transaction. Another possibility is that the Service is reclassifying the

74. The reasons are varied. In some cases the kicker is intentionally negotiated for a longer period or is extended to accommodate the borrower’s cash flow needs. In others, it is caused by an accelerated schedule of repayment, with the principal of the loan amortized prior to the sellout of the project. The latter is typical of construction and development loans.

75. The author understands that the REIT made a three-year development loan and negotiated a $1500 lot release fee which extended for seven years, with a balloon payment at that time on all unsold lots. The Service’s position was that the contingent interest was not “interest” for purposes of the 75% or 90% tests, even as to amounts paid during the term of the loan. They did not, however, contend that the trust was holding property primarily for sale; i.e., no passivity question was raised.

76. See Prospectus, dated July 20, 1972, of Institutional Investor’s Trust, at 5, which states that “the Internal Revenue Service held that if additional interest may be received after a loan is paid in full, any additional interest received at any time on such loan would not qualify as ‘interest’ for purposes of the 75% and 90% income tests. . . .”

77. If a REIT, in consideration of the Service’s position, sought to sell the loans which contained such equity kickers, it could be deemed to be holding property primarily for sale to customers in the ordinary course of its business. Perhaps it could be argued that the trustees, in selling the tainted loans, were merely complying with their fiduciary duty to protect the trust from disqualification and did not intend to violate the holding for sale provision of section 856(a)(4).


79. See Int. Rev. Code of 1954, § 163, which allows a deduction for interest paid or accrued on “indebtedness.” An argument could be made that the character of these payments is determined by the intent of the parties at the time the loan is negotiated, and that if they are in fact being made and required as compensation for the use and forbearance of money (instead of as an equity interest in the project), the timing of their receipt by the trust should be immaterial. Even if the payments ultimately are not secured by a mortgage or by an interest in real property, they should qualify as interest, at least for the 90% income test.

80. The REIT could negotiate the right to sell, assign or transfer the contingent in-
debt as an equity interest under the rationale of section 385. If so, then not only the contingent interest but also the fixed interest would not qualify for the 75% income test.

It has been suggested that the Service is applying the Code and regulatory provisions dealing with the definition of what is and is not "rent from real property" for the determination of what is "interest" for purposes of the 75% and 90% income tests. In other words, the Service seems to be taking the position that interest for purposes of section 856 has a different and more restricted definition than for other sections of the Code and as defined by the courts.

Carrying this position through to its logical (or illogical) conclusion, it would mean that where the Service has determined that the contingent interest received is unqualified because it is based on the net income or profits of the borrower (or where the borrower's gross income is based on the net income of another), then not only is the contingent interest disqualified but also the fixed interest. Thus, even where the REIT did not receive a contingent interest beyond the term of the loan, the contingent and fixed interest could be subject to treatment as unqualified income. The first published effort by the Service in establishing this position is that taken in the proposed regulations.

C. Equity Interests in Properties Financed

In some cases the borrower is willing to either convey or give an option to the trust to purchase some portion of the project, usually at a price well below market value. This usually occurs where the trust has made a "seed" money, development or land loan. Some variations of this type of equity kicker are: (1) an option to acquire, or the acquisition of, a specific portion of the land, improvements or both; (2) an option to acquire, or the acquisition of, an undivided interest in the land, improvements or both; (3) an option to acquire, or the acquisition of, all of the land; (4) an option to acquire an interest in the borrowing entity where it is a partnership or proprietorship; (5) convertible debentures, convertible into a limited or general partnership interest; or (6) a sale-lease-back.

81. Such a position has no support in the legislative history of the REIT sections, in the regulations thereunder, or in published rulings. There is no restrictive definition of interest in the REIT regulations as there is for "rents from real property." Further, these two types of income are not similarly treated in the application of other Code sections.

82. If so, this is a departure from its position in a private ruling dated March 15, 1972, which stated: "Nothing in Section 856 of the Code indicates that the word 'interest' is used differently than as defined above." See Deputy v. Dupont, 308 U.S. 488 (1940), on which the ruling relied, and Old Colony R.R. Co. v. Commissioner, 284 U.S. 552 (1932).


84. This type of equity kicker more properly might be treated under the stock, war-
One of the initial considerations for the trust is whether to take actual ownership or an option. Where ownership is acquired, the trust will generally realize income reportable over the life of the loan in an amount equal to the difference between the purchase price and the value of the property. Since future construction and development of the property is contemplated, the trust must be cautious not to allow the borrower-developer's activities to be imputed to the trust. If the trust's property is being developed by the borrower simultaneously with his own, the Service may raise the specter of joint venture or partnership causing passivity problems. This can be partially relieved by the trust net leasing the property back to the borrower.

An option will eliminate some of these problems but probably will not be considered an "interest in real property;" therefore, the income will qualify only for the 90% income test. Even where an option is taken, the option price is usually so nominal that an argument can be made that, in substance, ownership was acquired immediately. This problem is further complicated where an undivided interest is taken (by option or fee ownership) and the development scheme is either mixed or undetermined, since it is difficult to segregate or control the activities of the borrower-developer. Taking an ownership position in a specific portion of the land, as opposed to an undivided interest, is sometimes unattractive where the development is mixed or undetermined, since the trust runs the risk of selecting a parcel which will not yield as large a return as another.

By analogy to the Service's position on stock acquired as additional "interest", this method would seem to be appropriate and the income would qualify for the 75% and 90% income tests. If the borrower is a corporation, it could be argued that the value of the equity interest produces original issue discount, accounted for over the life of the loan. Even where the borrower is not a corporation, there is no reason why section 1232 principles should not be applicable. If not, then the value may have to be accounted for in the year of receipt, thus, increasing the REIT's taxable income, of which 90% must be distributed to its shareholders.

For further discussion of the considerations this raises, see Oppenheimer, REIT's Seeking Equity Kickers Travel a Perilous Sea, 2 (Part 4) REAL ESTATE REV. 31, 35 (Winter 1972).

While this would have the effect of qualifying the "interest" for purposes of the 75% income test, it raises the other problems discussed in connection with actual ownership. Perhaps the greatest detriment, however, from a reclassification standpoint, is that usually steps are not taken to protect against reclassification, thereby causing a potentially far more dangerous problem than those recognized initially and accounted for. H.R. 11083 would expand the statutory definition of interests in real property to include options to purchase such property. This would qualify the income and asset for the 75% income and asset tests.

"Mixed" implies a concurrent development of apartments, shopping centers and single family residences, etc.

For example, if the trust is negotiating for 10% of the revenue from the project
When an option is taken rather than fee ownership, then it should be in recordable form for security and also tailored to anticipate a possible reclassification or joint venture determination by the Service. 90

Section 856(c)(4) provides, in part, that a REIT must have less than 30% of its gross income from the sale or other disposition of stocks or securities held for less than six months and real property (including "interest in real property") not compulsorily or involuntarily converted, held for less than four years. Should the trust receive a substantial number of real property kickers (or a lesser number with greater value), it must be careful to avoid dispositions in any single year which result in more than 29% of its gross income, unless the property and other similarly treated assets have been held for the prescribed period. 91

As indicated previously, a land purchase leaseback is one method of achieving yield and growth from the property kicker, as well as insulation from the activities of the borrower-developer. In these situations, the REIT purchases the real property and leases it back to the original owner for a term of years. The lease typically provides for a minimum fixed rental and for a contingent rent based on a percentage of gross rent or sales of the tenant. This creates some difficulty in valuing the kicker and would not lend itself to original issue discount treatment. In most cases, the only way to account for the kicker is to take the contingent rent into income when the amount is reasonably ascertainable (in the case of accrual basis trust) or when received (in the case of a cash basis trust). 92

and yet takes 10% of the land, it might not receive 10% of the actual revenue if it selects the wrong parcel.

90. For example, if the REIT negotiated an option to receive a 10% undivided interest in a rental project, it could provide that its option was not exercisable until the project was completed, at which time the trust would exercise its option and either sell its interest or establish an independent contractor to operate the project. Thus, the REIT can argue that: (a) the option cannot be deemed instant ownership due to the restriction on its exercise; and that (b) the activities of the borrower should not be attributable to the trust since it has no control or opportunity to control the borrower's actions during development and construction. The same technique can be used in a residential or condominium project, except that the option would not be exercisable until the construction lender was repaid and controls would have to be established on the sales proceeds. Obviously, if there is serious concern regarding what position the Service might take, the safest approach would be to seek a private ruling.

91. In order to avoid the holding for sale problems, the trust must be careful of the manner in which it disposes of the property (marketing, sales promotion, bulk sales versus individual parcels), as well as the volume of sales. In the Prospectus of the Institutional Investors Trust, dated July 20, 1972, it was indicated the Service had ruled that the mere existence of a repurchase option in a land purchase leaseback transaction would not cause the trust to be considered as holding the investment primarily for sale to customers in the ordinary course if its business during the period that the option was unexercisable; but the Service did not rule on the status of the trust during the period that the option was exercisable.

92. A discussion of the various types of sale-leasebacks and their business and legal considerations is beyond the scope of this article. There are some excellent discussions on the topic in Hershman, Usury and the "New Look" in Real Estate Financing, 4 REAL PROP. PROB. & TRUST J. 315 (1969); Gunning & Roegge, Contemporary Real Estate Financing Techniques, 3 REAL PROP. PROB. & TRUST J., 325 (1968); Oppenheimer, REITs Seeking Equity Kickers Travel a Perilous Sea, 1 (Part 4) REAL ESTATE REV. 31, 36 (Winter 1972); P.L.I. SALE AND LEASEBACK FINANCING, NO. 6 (1969).
EQUITY PARTICIPATIONS

D. Partnership Interests

The Service has, in published and private rulings, as well as in its regulations, sanctioned a REIT's participation as a general or limited partner. The trust shall be deemed to own its proportionate share of the partnership assets and entitled to the income attributable to same. Such interest is determined in accordance with the trust's capital interest in the partnership. The character of the assets and income of the partnership is retained in the hands of the trust for all purposes of section 856. Where the partnership sells real property or the trust sells its interest in the partnership, any gross income from that sale attributable to the real property shall be deemed gross income from the sale or disposition of real property for the shorter of either the period that the partnership held the property or the period the trust was a partner. These same rules are applied to limited partnership interests.

Thus, if the partnership owns property which, if owned directly by the trust, would be considered "real estate assets" under section 856(c)-(6)(B), the trust interest in the partnership will be deemed to be an interest in "real estate assets" as used in section 856(c)(5)(A). Likewise, to the extent that the partnership's gross income would qualify as "rents from real property" or as "interest on obligations secured by a mortgage on real property or on interests in real property" if earned directly by the trust, such income will retain that same character when received by the REIT.

The rights and responsibilities of a limited partner, if such be the interest taken by the REIT, should be carefully explored under the partnership statutes. Other state law considerations are also relevant.

The REIT must assure itself, by whatever controls and contractual provisions are necessary, that the partnership and the partners are restricted in their type of income and assets, as well as activities. Even


96. For example, under the Uniform Limited Partnership Act, a limited partner dealing with the partnership is subject to certain restrictions including in effect a preclusion from receiving collateral security. Uniform Limited Partnership Act § 13. Also, substantial control over the partnership activities, which a REIT would be inclined to demand to avoid disqualification, might jeopardize its limited partnership status.

97. In Kessing v. National Mortgage Corp., 278 N.C. 523, 180 S.E.2d 823 (1971), the court cancelled a partnership agreement between a borrower and lender and held that a loan by the lender at the maximum rate plus a kicker of 25% of the profits of the partnership was usurious. In so holding, the court found that the partnership interest of the lender (obtained for $25) was clearly a "thing of value" under the North Carolina interest statute. See Hershman, Usury and the Tight Money Market, 24 Bus. Law. 1121 (1969).

98. Another potential problem relating to attribution of ownership under Int. Rev.
with all the appropriate controls and restrictions on the partnership, the general partner may, inadvertently or intentionally, breach its agreement, leaving the trust disqualified, although admittedly with the right to damages. 99

VI. Conclusion

The negotiation and structuring of equity kickers represent an area of potential exposure of the REIT far greater, in many respects, than the more formalistic requirements of the Code. What must be blended in each case where an equity kicker is involved are the economic desires of the trust and the realistic exposure under the Code, regulations and rulings pertaining to its operations.

99. For example, if a REIT were a general partner in a limited partnership and owned more than a 10% capital interest in the partnership and the partnership was found to be an association taxable as a corporation, it would probably follow that the REIT owned more than 10% of the voting stock of an issuer.