How to Form a REIT (Real Estate Investment Trust)

Companies owning or financing real estate must meet a number of organizational, operational, distribution and compliance requirements to qualify as a real estate investment trust (REIT). These rules govern issues such as dividend distributions and the composition of a company's assets.

The following offers a general summary of the basic tax law requirements applicable to REITs. To qualify as a REIT, an entity must meet a number of organizational, operational, distribution, and compliance requirements.

1. **How must a real estate company be organized to qualify as a REIT?**

A U.S. REIT must be formed in one of the 50 states or the District of Columbia as an entity taxable for federal purposes as a corporation. It must be governed by directors or trustees and its shares must be transferable. Beginning with its second taxable year, a REIT must meet two ownership tests: it must have at least 100 shareholders (the 100 Shareholder Test) and five or fewer individuals cannot own more than 50% of the value of the REIT's stock during the last half of its taxable year (the 5/50 Test).

To ensure compliance with these tests, most REITs include percentage ownership limitations in their organizational documents. Due to the need to have 100 shareholders and the complexity of both of these tests, it is strongly recommended that tax and securities law counsel are consulted before forming a REIT.

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2. **How do REITs operate?**

A REIT must satisfy two annual income tests and a number of quarterly asset tests to ensure the majority of the REIT's income and assets are derived from real estate sources.

At least 75% of the REIT's annual gross income must be from real estate-related income such as rents from real property and interest on obligations secured by mortgages on real property. An additional 20% of the REIT's gross income must be from the above-listed sources or other forms of income such as dividends and interest from non-real estate sources (like bank deposit interest). No more than 5% of a REIT's income can be from non-qualifying sources, such as service fees or a non-real estate business.

Quarterly, at least 75% of a REIT's assets must consist of real estate assets such as real property or loans secured by real property. A REIT cannot own, directly or indirectly, more than 10% of the voting securities of any corporation other than another REIT, a taxable REIT subsidiary (TRS) or a qualified REIT subsidiary (QRS). Nor can a REIT own stock in a corporation (other than a REIT, TRS or QRS) in which the value of the stock comprises more than 5% of a REIT's assets. Finally, the value of the stock of all of a REIT's TRSs cannot comprise more than 20% of the value of the REIT's assets.

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3. **What are the dividend distribution requirements for a REIT?**

In order to qualify as a REIT, the REIT must distribute at least 90% of its taxable income. To the extent that the REIT retains income, it must pay taxes on such income just like any other corporation.

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4. **What are the compliance rules for becoming a REIT?**

In order to qualify as a REIT, a company must make a REIT election by filing an income tax return on Form 1120-REIT. Since this form is not due until March, the REIT does not make its election until after the end of its first year (or part-year) as a REIT. Nevertheless, if it desires to qualify as a REIT for that year, it must meet the various REIT tests during that year (except for the 100 Shareholder Test and the 5/50 Test, both of which must be met beginning with the REIT's second taxable year).

Additionally, the REIT must mail annual letters to its shareholders requesting details of beneficial ownership of shares. Significant penalties will apply if a REIT fails to mail these letters on time.

For more information concerning the legal requirements applicable to REITs, please consider purchasing West Group's publication "Real Estate Investment Trusts Handbook"

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