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WHY DO PROPERTY REITS HAVE OPERATING PARTNERSHIPS: REIT OP UNITS AS A TAX-ADVANTAGED CURRENCY FOR PROPERTY ACQUISITIONS

REIT Series – Q2 Update

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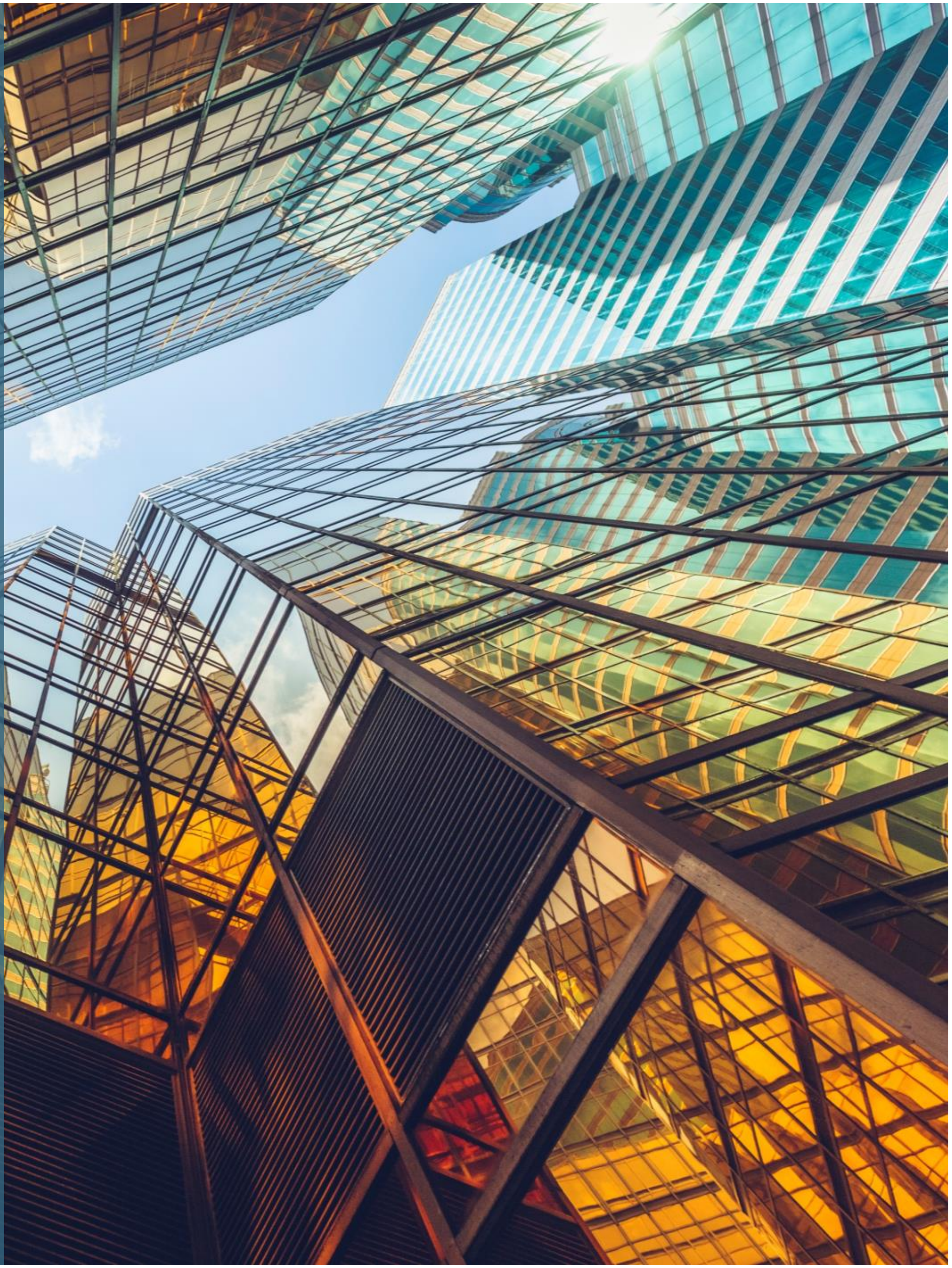

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UPREITs
History of the UPREIT Structure

- In the early 1990s, the commercial real estate industry experienced a significant downturn
  - The real estate capital markets dried up
  - Banks, thrifts, pension funds and insurance companies stopped lending
  - Many commercial real estate companies needed to raise equity to pay down debt
- At the same time, Wall Street began to look to the REIT structure
  - In 1991 and 1992, nine equity REIT IPOs were completed
  - In 1993, 44 equity REIT IPOs were completed
- What changed?
  - The first UPREIT structure was put in place in connection with the Taubman Centers IPO in 1992
  - Prior to 1992, a typical REIT formation transaction involved the transfer of real estate assets (or interests in real estate assets) to a REIT in exchange for cash, REIT stock or a combination of the two — this type of transaction generally is taxable
  - The UPREIT structure overcomes these tax difficulties and provides a path for private real estate companies (typically operating through private investment partnerships) to contribute properties to a permanent capital vehicle and access the equity capital markets without triggering a significant tax bill for the current owners

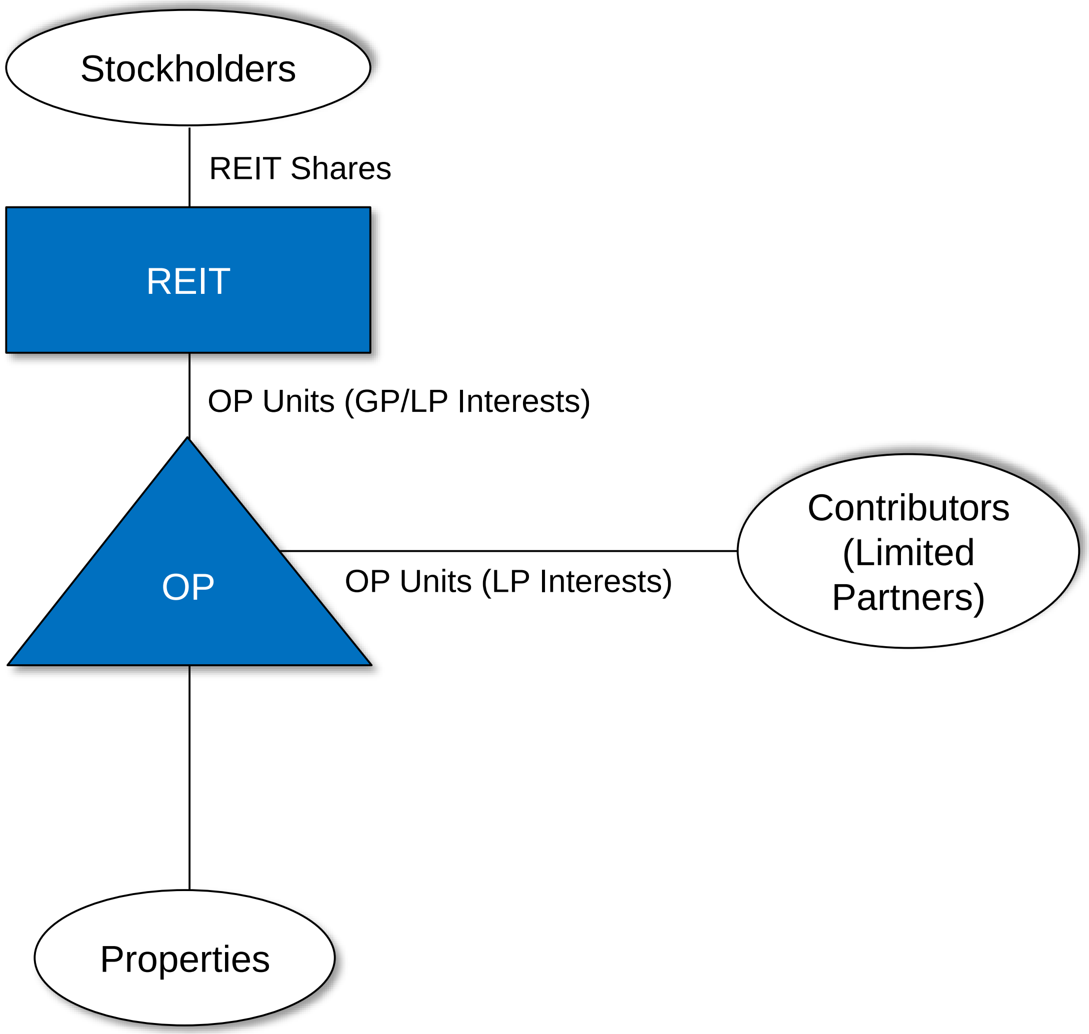
UPREITs
Typical UPREIT Structure

- An UPREIT (short for "umbrella partnership real estate investment trust") describes a structure in which a REIT owns all of its properties and conducts all of its business through a limited partnership subsidiary known as an operating partnership (the "**OP**")
- The UPREIT structure is the most common operating structure for publicly traded equity REITs
- The UPREIT structure allows property owners to transfer their interests in property-owning entities or their properties to a REIT without current taxation
- Instead of contributing properties directly to the REIT for cash or shares of the REIT's common stock **("REIT Shares"),** which is ordinarily a taxable transaction, property owners can contribute either their interests in property-owning entities or their properties to a newly formed or existing OP in exchange for common units of limited partnership interest in the OP ("**OP Units**") on a tax-deferred basis

Typical UPREIT Structure

- In a typical UPREIT structure, the REIT is the sole general partner of the OP (or it controls the sole general partner of the OP)
- The REIT is also a limited partner of the OP and usually owns a majority of the outstanding OP Units
  - The REIT's only material assets consist of its OP Units
  - The REIT receives its OP Units in exchange for the contribution of the cash proceeds from its IPO or other offering and sale of REIT Shares (the REIT holds a number of OP Units equal to the number of outstanding REIT Shares)
  - Whenever the REIT issues and sells additional REIT Shares, the REIT contributes the proceeds from the sale of REIT Shares to the OP in exchange for additional OP Units
  - Similarly, when the REIT issues and sells preferred shares, it contributes the cash proceeds to the OP in exchange for a series of preferred units that mirror the economic terms of the series of preferred shares issued and sold by the REIT
- The remainder of the OP Units are held by limited partners (other than the REIT) who contributed their interests in property-owning entities or their properties to the OP in exchange for OP Units on a tax deferred basis

UPREITs
Typical UPREIT Structure



UPREITs
OP Units

- OP Units are economically equivalent to REIT Shares
- Holders of OP Units, including the REIT, receive per unit cash distributions equal to per share cash dividends paid by the REIT to the holders of REIT Shares
- Typically after a one-year holding period, limited partners (other than the REIT) have the right to require the OP to redeem some or all of their OP Units
- Once OP Units have been tendered for redemption, the REIT may elect either to:
  - Cause the OP to pay cash for the redeemed OP Units based on the market price of a REIT Share at the time of redemption; or
  - Issue REIT Shares in exchange for the redeemed OP Units on a one-for-one basis
- REITs usually elect to issue REIT Shares in exchange for redeemed OP Units rather than paying cash

UPREITs
OP Units

- The redemption of OP Units, whether for cash or REIT Shares, is a taxable transaction
  - An OP Unitholder receiving REIT Shares would generally recognize capital gain based on the difference between the value of the REIT Shares received and the holder’s tax basis in the redeemed OP Units
  - The holder’s tax basis in the redeemed OP Units would typically be a “carryover” basis from the holder’s contributed property, increased by the holder’s allocable share of the OP’s liabilities and decreased by any liabilities assumed by the OP
  - The holder’s tax basis in the redeemed OP Units would also be increased by allocations of income to the holder and decreased by distributions to the holder
- Gain from the redemption of OP Units will generally be capital gain

UPREITs
OP Units

- Because REITs typically elect to issue REIT Shares in exchange for redeemed OP Units rather than paying cash, it is expected that a redeeming limited partner will immediately sell a portion of the REIT Shares it receives in the redemption in the public market and use the proceeds to pay taxes
- In order to immediately sell REIT Shares in the public market, the issuance of the REIT Shares or the resale of the REIT Shares must be registered under the Securities Act of 1933 (the "**Securities Act**") or exempt from registration
- REITs typically agree to register the issuance and resale of the REIT Shares issuable upon the exchange of redeemed OP Units because
  - Prior to March 2016, Rule 144 under the Securities Act (a safe harbor from registration for resales of restricted securities) was not viewed as being available for immediate resales of REIT Shares issued in exchange for redeemed OP Units
- In March 2016, the SEC issued a no-action letter that permitted holders of REIT Shares received in exchange for privately placed OP Units to tack the holding period of the OP Units to the REIT Shares for purposes of satisfying the Rule 144 holding period
  - As a result of the SEC's interpretative guidance, a redeeming limited partner may immediately resell the REIT Shares issued in exchange for the redeemed OP Units under Rule 144 so long as the redeemed OP Units and REIT Shares have been held, on a combined basis, for at least six months

UPREITs
Benefits of Contributing Properties to an UPREIT

- When structured properly, contributions of properties to an OP in exchange for OP Units can be accomplished on a tax deferred basis
  - REITs can use the tax deferral advantage of the UPREIT structure to acquire properties with OP Units instead of paying cash not only at formation but also throughout the life of the REIT
- By contributing interests in a single property or a small group of properties in exchange for OP Units, contributors participate in the performance of a larger pool of properties and mitigate the impacts of a decline in the value or performance of a particular property or group of properties
- OP Unitholders can obtain liquidity by exercising their redemption rights at times, and in amounts, of their choosing, which gives them flexibility to decide when to monetize their holdings and trigger their tax liability
- Because OP Units are economically equivalent to REIT Shares and can be exchanged for REIT Shares on a one-for-one basis, OP Unitholders can establish the fair market value of their OP Units and borrow against that value
- When an individual OP Unitholder holds OP Units until death, the tax rules generally allow for a “step up” in tax basis of the OP Units, effectively permitting the beneficiaries of the individual’s estate to tender the OP Units for redemption without incurring tax on the built-in gain in the OP Units at the time of death

UPREITs
Risks of Contributing Properties to an UPREIT

- OP Units typically do not have voting rights at the REIT level and have only limited voting/consent rights at the OP level
  - Some UPREITs have created a special class of voting stock at the REIT level to provide OP Unitholders with voting rights to align with their overall equity investment
- Because the REIT could be delisted from the exchange on which the REIT Shares are traded, there might be little or no liquidity for the REIT Shares issuable upon exchange of redeemed OP Units
- If a contributing limited partner becomes an “affiliate” of the REIT, the contributing limited partner could have reduced liquidity due to insider trading prohibitions or the short swing profits rule of Section 16 of the Securities Exchange Act of 1934
- When the contributing limited partner is relying on the contribution to defer tax obligations, loss of control regarding the future sale or refinancing of the contributed property can be a particularly sensitive issue because the future sale or refinancing would cause the contributing limited partner to incur a tax liability
  - This risk is somewhat mitigated by the use of a tax protection agreement

UPREITs
Key Terms of Tax Protection Agreements

- Lock-out on property sales
  - Typically a prohibition on disposing of contributed properties for a negotiated period of time
- Maintenance of certain debt levels
  - OP covenants to maintain sufficient debt to allow contributors to “cover” their negative tax capital accounts
- Ability to make “vertical slice” guarantees of OP debt
  - To the extent OP’s debt won’t cover negative capital accounts under general 752 rules, vertical slice guaranty may be used to make necessary portion of debt recourse to the contributor
- Depreciation method (traditional vs. others)
  - Contributors typically negotiate for traditional method
- Indemnity for breach
  - OP/REIT owe an indemnity payment for a breach, typically in the amount of the built-in gain at the time of contribution that gets triggered by their subsequent breach.
  - Many agreements also contain a tax gross-up of the damages amount, but that is a negotiated point.
- Term of the Agreement
  - Number of years is a heavily negotiated point

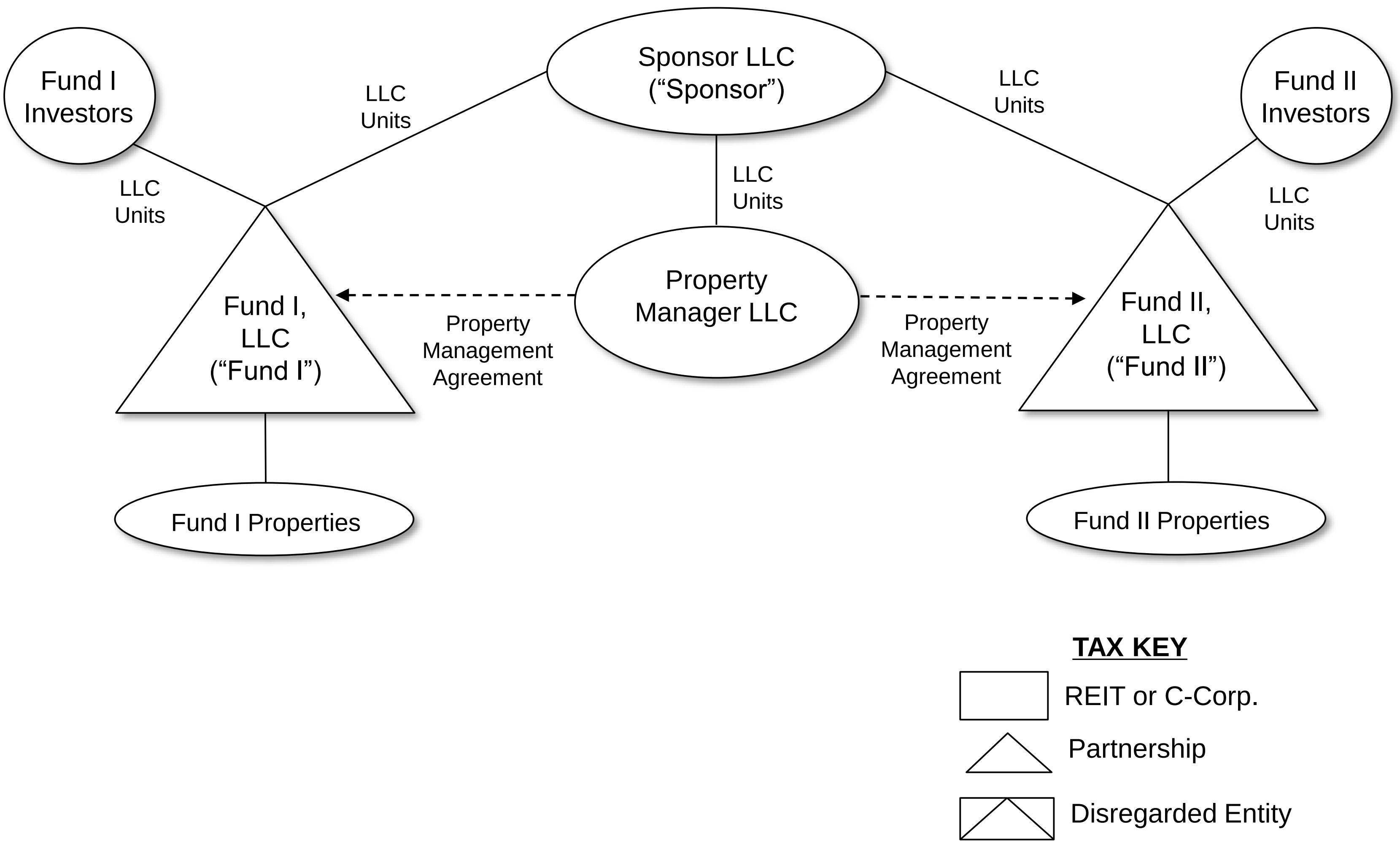
UPREITs
Certain Tax Issues

- Although the UPREIT structure allows owners of real estate to contribute real property or ownership interests in a real property-owning entity to the OP without the recognition of gain under I.R.C. Section 721, there is still the potential for gain recognition in using an UPREIT structure
- Among the additional tax issues that need to be considered are:
  - The applicability of the disguised sales rules under I.R.C. Section 707(a)(2)(B)
  - The applicability of the marketable securities rules under I.R.C. Section 731(c)
  - The applicability of the deemed distribution rules under I.R.C. Section 752(b) to the reduction of any contributed debt and the post-contribution allocation of liabilities
  - Loss recapture under the "at-risk" rules in I.R.C. Section 465(e)
  - The application of I.R.C. Section 704(c) if, as is typically the case, the property contributed to the OP has built-in gain

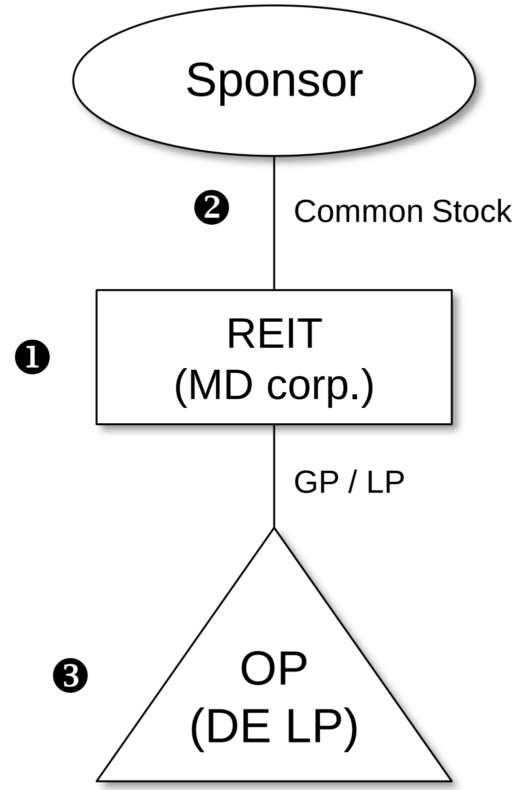
REIT ROLL-UPS
Overview

- A sponsor creates a new UPREIT structure
- The OP acquires the sponsor's management business and properties through one or more merger or contribution transactions in exchange for cash, OP Units or a combination of cash and OP Units
- The OP may also acquire minority interests in the sponsor's properties or additional properties from unaffiliated third parties in exchange for cash, OP Units or a combination of cash and OP Units
- The REIT simultaneously completes an IPO or private offering of its common stock

REIT ROLL-UPS
Illustrative Transaction: Contributor Structure Prior to Roll-Up



REIT ROLL-UPS
Illustrative Transaction: Formation of the REIT and the OP

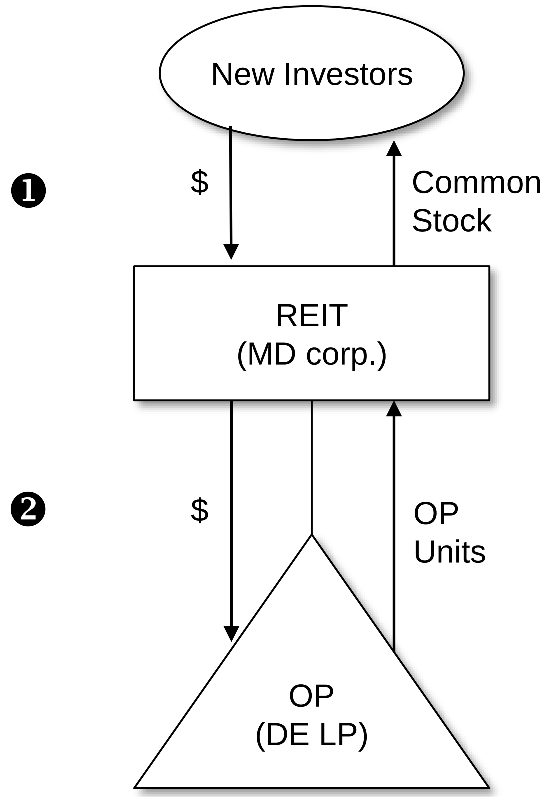


❶ Sponsor incorporates the REIT in Maryland.

❷ Sponsor capitalizes the REIT and is the sole stockholder prior to the IPO.

❸ Sponsor forms the OP in Delaware. REIT is the sole initial GP and the sole initial LP of the OP.

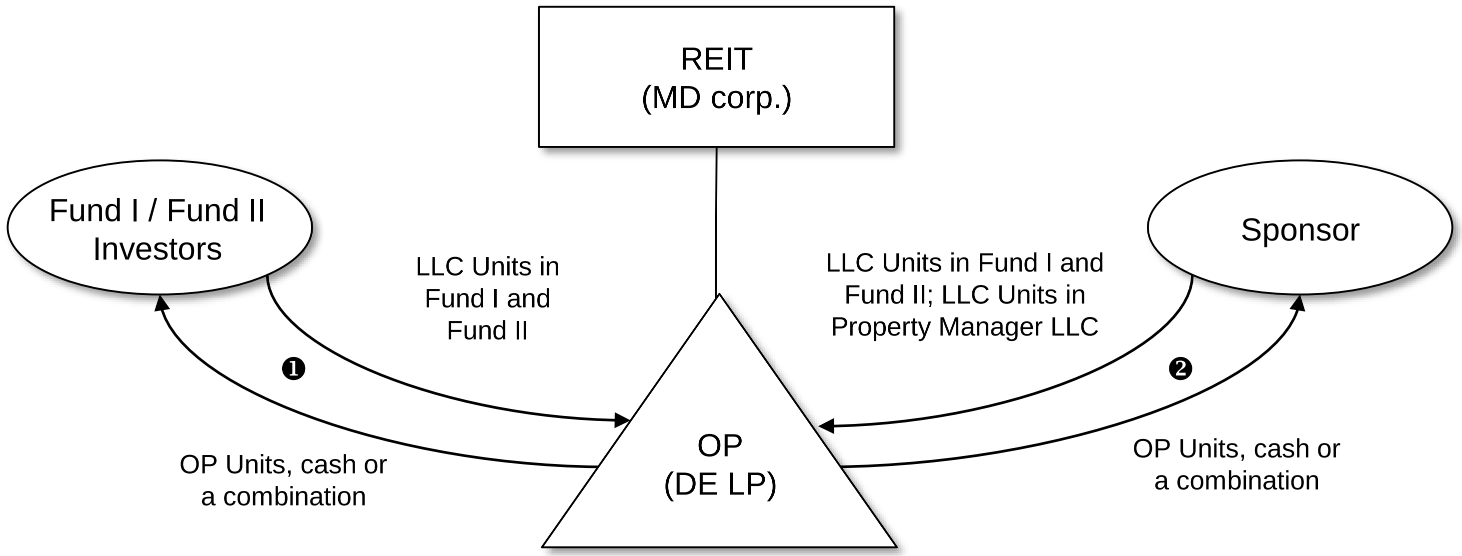
REIT ROLL-UP
Illustrative Transaction: REIT Completes IPO of Common Stock for Cash



❶ REIT sells shares of its common stock in the IPO to new investors.

❷ REIT contributes the cash proceeds from the IPO to the OP in exchange for OP Units. The number of OP Units issued by the OP to the REIT equals the number of shares of common stock sold by the REIT in the IPO.

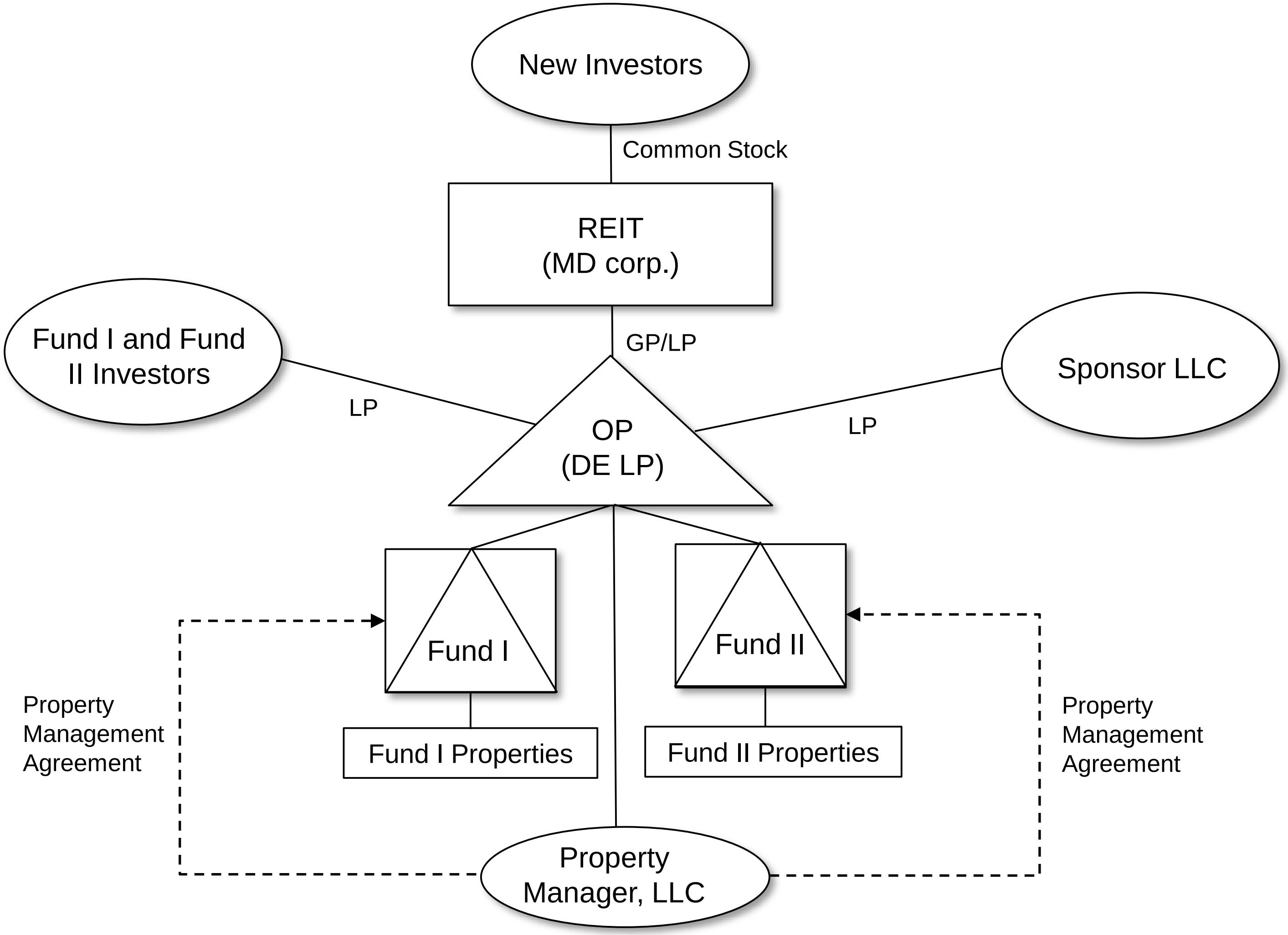
REIT ROLL-UPS
Illustrative Transaction: Contribution Transactions (Step Occurs Concurrently with the Closing of the IPO)



❶ Fund I Investors and Fund II Investors contribute LLC Units in Fund I and Fund II to the OP pursuant to a contribution or merger agreement. The investors may elect to receive OP Units, cash or a combination of OP Units and cash in exchange for their LLC Units. An election to receive OP Units generally results in a tax-deferred contribution under I.R.C. Section 721.

❷ Sponsor contributes LLC Units in Fund I and Fund II and its LLC Units in Property Manager LLC to the OP pursuant to a contribution or merger agreement. If the managing member of each fund has a carried interest or promoted interest, it gets crystalized in the contribution or merger. Sponsor may elect to receive OP Units, cash or a combination of OP Units and cash in exchange for its LLC Units in Fund I and Fund II, crystalized carried interest in Fund I and Fund II and its LLC Units in Property Manager LLC. An election to receive OP Units generally results in a tax-deferred contribution under I.R.C. Section 721.

REIT ROLL-UPS
Illustrative Transaction: UPREIT Structure After the Roll-Up



REIT ROLL-UPS
Primary Transaction Documents

- Contribution or merger agreements
- Disclosure document (typically a consent solicitation memorandum, a merger proxy or an information statement)
- Consideration election form
- Partnership agreement of the OP to reflect the UPREIT structure and the admission of the contributors as new limited partners
- Registration rights agreement relating to the REIT Shares issuable to limited partners in exchange for redeemed OP Units (typically included in the partnership agreement)
- REIT charter and bylaws
- Tax protection agreement

REIT ROLL-UPS
Economic Issues

- Determining the number of OP Units issuable in exchange for the contributed equity interests or properties and the sponsor's management business being contributed to the OP requires an agreement on the value of the entire portfolio and the management business and how that value is to be allocated among the contributors and the sponsor
  - Use of a fixed exchange ratio causes contributors to share IPO pricing risk
  - Use of a fixed value for the contributed assets insulates contributors from IPO pricing risk, but can lead to marketing/pricing issues in the IPO
- Because the REIT roll-up is an affiliate transaction, it may be subject to particular scrutiny and third party valuation experts are typically used and fairness opinions are frequently sought
- The value of each property-owning entity or property being contributed to the OP will typically be subject to pricing adjustments (*i.e.*, for the liabilities to which the underlying properties are subject at closing) and potentially prorations (rent, utilities, property taxes, etc.)
- The aggregate inside equity percentage of the contributors and the sponsor will be fixed based upon determination of the IPO price range and the size of the IPO

REIT ROLL-UPS
Legal Issues

- In order to complete the roll-up, each holder of an interest in a participating entity must agree to contribute its interests to the OP, or the transactions must be completed through a series of merger transactions pursuant to which non-consenting holders can be dragged along
  - Organizational documents of each participating entity must be reviewed to determine whether non-consenting holders can be dragged along, and if so, what threshold of approval must be obtained
- Lender consents may be required to complete the roll-up, and a review of underlying debt documents should be conducted
- Other major contracts should also be reviewed for consent issues (*e.g.,* hotel franchise agreements in connection with a hotel REIT roll-up)

REIT ROLL-UPS
Legal Issues

- The issuance of OP Units to roll-up participants is a securities offering and must be registered or exempt from registration
- Most roll-ups are conducted as private placements, and each OP Unit recipient must be an "accredited investor" — non-accredited investors get cashed out
- In a typical roll-up, the disclosure document includes, among other things, information regarding:
  - The material terms of the merger and contribution transactions
  - The valuation of the various equity interests and properties being acquired by the OP in the roll-up and how the valuation was determined
  - The level of approvals required to consummate the roll-up
  - The tax consequences of the roll-up
  - The REIT's strategy, market opportunity, industry and management
  - Risk factors
  - Benefits to related parties from the roll-up
  - The material terms of the OP's partnership agreement and the OP Units
  - Historical financial statements of the contributing partnerships, as well as historical financial statements for the combined entity and pro forma financial statements showing the effects of the roll-up, including the IPO and the use of IPO proceeds

REIT ROLL-UPS
Legal Issues

- Much of the disclosure that is given to roll-up participants also appears in the IPO prospectus included in the REIT's registration statement on Form S-11
- Typically, all required investor consents are obtained before the REIT files its registration statement on Form S-11 with the SEC
  - All required investor consents must be obtained before the REIT commences the IPO roadshow
- If the roll-up has to be registered under the Securities Act, in addition to the requirements of Form S-11 and SEC Industry Guide 5, Section 14(h) of the Securities Exchange Act of 1934 and Items 902 through 915 of Regulation S-K require significant additional disclosure on an overall and per partnership basis

PREFERRED OP UNITS
Overview; Distribution Rights

- Preferred Unit Transactions Generally
  - UPREITs can use preferred units of limited partnership interest in the OP (“**Preferred Units**”) to acquire properties on a tax-deferred basis
  - Preferred Units may be convertible into OP Units, which are in turn exchangeable for REIT Shares
  - Preferred Units rank senior to OP Units with respect to distribution and liquidation rights
  - Preferred Units generally are mandatorily redeemable on a specified date for an amount of cash equal to the face amount of the Preferred Units plus accrued but unpaid distributions
  - Potential disguised sale issues:
    - Timing of mandatory redemption
    - “Reasonable” preferred return
- Distribution Rights
  - Cash distributions are generally made at a fixed rate prior to distributions on OP Units
  - Timing of cash distributions (monthly, quarterly, semi-annually, annually, *etc.*) is typically negotiated
  - Notwithstanding the priority of the Preferred Units, the OP is typically permitted to make distributions to the REIT, as a holder of OP Units, prior to making distributions to the holders of Preferred Units if necessary to permit the REIT to make distributions to holders of REIT Shares to preserve REIT status

PREFERRED OP UNITS
Liquidation Rights; Conversion Rights

- Liquidation Rights
  - Holders of Preferred Units are entitled to receive a liquidating distribution prior to a liquidating distribution being made to holders of OP Units
- Conversion Rights
  - Conversion from Preferred Units to OP Units is typically at a premium to the value of an OP Unit / REIT Share at the time of issuance
  - Upon conversion to OP Units, a contributing limited partner has the same rights as other OP Unitholders, including OP Unit redemption rights
  - Conversion from Preferred Units to OP Units generally does not result in taxable gain recognition

THANK YOU

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