REAL ESTATE
LAW UPDATE
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Message from the Co-Chairs

"REIT It And Don't Weep!"

Taking advantage of a promising market and favorable tax treatment, a major landowner client engaged us to establish a REIT. We've also been tapped by Reckson in a class action lawsuit challenging the validity of the sale of the Reckson REIT to SL Green. In this issue we discuss the features and advantages of REIT ownership, and analyze recent cases and statutory law affecting real estate professionals.

If either of us can be of service or you have questions about any real estate issue, please feel free to contact us at 516-663-6600.

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REITs: An Overview

by Adam P. Silvers, Esq. and Michael I. Schnipper, Esq.

As history has shown, investment in real estate can provide investors with the benefits of current income and the potential for large capital gains. However, direct investment in real estate is often too expensive for the average investor. Other pitfalls to investment in property include liquidity problems, uncertain operating expenses, and lack of experience in the selection of a viable investment property and how to properly manage real property. An exciting alternative investment, which provides for similar advantages without the corresponding pitfalls, is the Real Estate Investment Trust, commonly known as a "REIT".

REITs are much like mutual funds for real estate[1] in that investors purchase interests in an entity which then purchases and operates a diversified portfolio of real estate. Most REITs dedicate their resources to the ownership of interests in real estate such as apartment complexes, homes, office buildings, warehouses, malls, etc. This type of REIT is known as an "Equity REIT" and its revenue is derived from rental income. A second type of REIT, known as a "Mortgage REIT," is an entity dedicated to making loans secured by interests in real property. The revenues for Mortgage REITs are derived from the interest earned on mortgage loans. Certain REITs combine these investment approaches ("Hybrid REITs").

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ALERT: BROWNFIELD TAX CREDITS FOR CONDOS AND CO-OPS

New York's Brownfield Cleanup Program, enacted in 2003, has been recently amended to allow residential condominiums and co-operatives to qualify for Brownfield tax credits. The amendment is effective immediately. Specifically, residential condominiums and co-ops now qualify for the Brownfield Redevelopment Tax Credit (BRTC). These credits provide up to a maximum of 22% of the cost of site preparation, groundwater remediation and investment in tangible property (including buildings) as a refundable tax credit. To qualify for the BRTC, a residential condominium or co-op must be acquired by a purchase and be located on a qualified site (i.e., a site for which a Certificate of Completion has been issued by the Department of Environmental Conservation). A developer is eligible for the credit when a certificate of occupancy is issued for the property.

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The benefits of REITs to the organizers are purely tax-driven. First authorized by Congress in the 1960s, REITs enjoy the benefits of "pass-through" status for income tax purposes, much like "S" corporations and limited liability companies. The pass-through status is a product of the REIT's ability to deduct all amounts distributed from investors from its annual income when determining its taxable income. As discussed below, REITs are statutorily required to distribute at least 90% of their taxable income.

In order to enjoy these tax benefits, REITs must strictly follow a set of very comprehensive rules set forth in the Internal Revenue Code.[2] A REIT must be a corporation, business trust or similar association taxable for federal purposes as a corporation, which is managed by a board of directors or trustees. Interests in a REIT must be freely transferable. All REITs must use the calendar year as their fiscal year.

Beginning with their second taxable year, REITs must satisfy two ownership tests. A REIT must have at least 100 distinct and identifiable stakeholders, and five or fewer individuals may not own more than 50% of the value of the REIT's stock during the second half of its taxable year. In order to comply with the ownership requirements, the organizational and governance documents of REITs often limit the percentage ownership that each stakeholder may have.[3] These ownership limitations have been deemed by the IRS not to violate the requirement that interests be freely transferable.

The IRS also mandates testing of a REIT's income and assets in order to ensure that a REIT is truly engaged in the real estate business. In each taxable year, at least 75% of a REIT's gross income must be derived from real estate activities. In other words, three quarters of a REIT's income must come from rents on property or interest earned on loans secured by real property. 95% of a REIT's annual gross income must be derived from real estate as required in the 75% test (described in the next paragraph) and dividends and interest from non-real estate investments.

At the close of each quarter, a REIT's asset portfolio must be made up of at least 75% real estate (including real property and mortgages secured by real property). A REIT's ownership interest in another REIT can be counted towards compliance with the 75% asset composition test. However, ownership in other REITs cannot comprise more than 20% of a REIT's asset portfolio.

Perhaps most intriguing to investors is the requirement that a REIT distribute at least 90% of its taxable income to its stakeholders. These distributions can be deducted from the REIT's taxable income for the tax year. Therefore, REITs distributing 100% of their taxable income for a tax year are exempt from corporate income tax for that tax year. In other words, the income distributed to the stakeholders is taxed only at the stakeholder level and not at the entity level. This requirement provides investors with a stable and, in many cases, sizable annual income.

There are many other benefits to investors considering an investment in REITs. Many REITs raise capital in the public markets and are often traded on stock exchanges. This provides REIT stakeholders with liquidity. REITs are often managed by professionals with a wealth of experience in the acquisition and operation of real property and the real estate market as a whole. Typical REITs hold portfolios of diversified properties and/or mortgages. This diversification provides investors with a hedged investment.

Companies considering the creation of or conversion into a REIT should seek immediate assistance from attorneys experienced in tax, securities, corporate governance and real estate law, as well as accountants versed in the sections of the Internal Revenue Code which deal with REITs. The operation of a REIT provides many advantages to management and the stakeholders, but the various applicable laws contain stringent regulations. Failure to satisfy all requirements may result in the loss of REIT status and therefore double taxation, a losing proposition for all parties. Early counseling is essential as REIT status is obtained through a filing with the Internal Revenue Service which occurs well after all corporate formation and governance decisions are made and implemented.

[1] REITs are permitted by the Internal Revenue Code to hold only one piece of property (an example is Rockefeller Center).

[2] A recent amendment to the Internal Revenue Code allows for temporary deviations from the requirements in very limited circumstances.

[3] REITs often do not permit stakeholders to own more than 9.9% of a REIT's stock without a waiver by the REIT's Board.

Invading the Tenant's Space – A Perilous Step No More

by Benjamin Weinstock, Esq.

In many jurisdictions the law is very clear that a landlord's encroachment on the tenant's space, regardless of how minimal, justifies a complete abatement of all rent. In fact, the infamous "not one inch" rule has been New York's law for more than 150 years. However, a recent decision by New York's prestigious Appellate Division, First Department, overruled this longstanding precedent.

In Eastside Exhibition Corp. v. 210 East 86th St. Corp., the tenant leased between 15,000 and 19,000 square feet of space for a quad movie theatre in Manhattan for a term of almost 20 years. The lease permitted the landlord to enter the tenant's premises at reasonable times to make repairs and improvements, but it did not permit the landlord to permanently encroach on the tenant's floor area. Approximately five years into the term, the landlord, without prior notice or permission, entered the tenant's premises and installed floor-to-ceiling steel cross-bracing occupying about 12 square feet of floor area in preparation for construction of two additional floors on the building.

The tenant withheld all rent and brought an action to both enjoin the landlord from doing any future work in the premises and to compel the removal of the cross-bracing. The tenant also asked for compensatory and punitive damages. The landlord served a series of default notices on the tenant and counterclaimed for rent and legal fees in excess of $630,000.

The trial court held that the landlord's invasion was not material and, therefore, did not warrant a total rent abatement. The court also permitted the landlord to leave the encroaching cross-bracing. The Appellate Division affirmed the lower court's decision, but went even further by declaring that the "not one-inch" rule was no longer good law in NY. Instead, the court remanded the case for a hearing to determine the tenant's damages.

Awarding compensatory damages to the tenant for the landlord's breach seems like a very natural and logical holding when viewed from the perspective of contract law. When viewed under the lens of the common law of real property, however, the holding is surprising because of its abandonment of hundreds of years of history and rejection of legal precedent.

The Common Law Lease

The common law considered a leasehold a temporary ownership interest in the land and not merely a contract for possession. In exchange for this "ownership" right, a tenant paid rent. If the tenant's right to possess the land was disturbed by the landlord, the landlord forfeited his right to the rent.

That Was Then - This is Now

The geographic and economic conditions that fomented the development of the common law have been entirely transformed in the modern urban landscape. We are no longer a predominantly agrarian society. Tenants today generally do not occupy the land. Rather, they purchase for their monthly rent a service from the landlord that not only includes the walls that enclose the space they occupy, but also encompasses light, water, power, communications, air-conditioning, vertical transportation, parking and even joint marketing programs. Parties view commercial leases primarily as contracts and not estates in land. As such, the Appellate Division's reliance on contract law rather than real estate law principles is appropriate.

Moving Forward

The Court's holding in Eastside is not necessarily grounds for celebration by landlords. Although clearly intended to protect the landlord from the inequitable loss of its entire rent, it may be the first step on a slippery slope of leasing law reforms that will eventually benefit tenants. It is not far-fetched to imagine how this leniency could backfire. Will a landlord no longer be entitled to reject the tenant's $19,000 rent check because it is only $12 short? Does this holding suggest the possibility that a lease is not violated where the rent is only late by a de minimus amount of time? What if the tenant invades a portion of the common area or another tenant's space? Will the landlord lose the right to require the removal of the tenant? Under principles of contract law, these results are possible if not probable.

The ultimate result of Eastside is not a comforting sense of closure. To the contrary, it casts a pall of foreboding over what will come next. In fact, it is foreseeable that landlords will at some point during the life cycle of a lease encounter a problem whose solution requires permanent installations that encroach into a tenant's space. The landlord's need or desire to do this work is far too important to subject it to the vagaries of state law and the costs and delays of the adjudicatory process. Therefore, landlords will add to their leases additional clauses that expressly permit intrusions into the tenant's premises. Cautious tenants will seek to limit this newfound right

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About **the Firm**

Founded in 1968, Ruskin Moscou Faltischek P.C. has emerged as Long Island's preeminent law firm. As specialized as we are diverse, we have built cornerstone groups in all of the major practice areas of law, and service a diverse and sophisticated clientele. With superior knowledge of the law, polished business acumen and proven credentials, Ruskin Moscou Faltischek has earned a reputation for excellence and success. It is this ongoing achievement that makes us an acknowledged leader among our peers and the preferred choice among business leaders.

The strength of Ruskin Moscou Faltischek's resources greatly enhances what we can accomplish for our clients – to not only solve problems, but to create opportunities. We take pride in going beyond what is expected from most law firms. The invaluable contacts and relationships we have nurtured in the business community and our multidisciplinary approach heighten our value-added services.

of landlords and relegate when, where and to what extent such invasion is permitted. This will undoubtedly contribute to making a lease negotiation even more contentious than it already is.

While it is certainly beneficial for landlords and tenants to keep Eastside in mind during lease negotiation, it would be wise not to rely too heavily on its decision. Eastside is certainly a landmark decision but its overturning of the "not one inch" rule has not yet been widely accepted. Just recently, in Sterling Investor Services, Inc. v. Nobo Associates, LLC, New York's Second Department issued a decision that also dealt with partial eviction and ignored Eastside (decided by the First Department). After being New York's law for more that 150 years, it is clear that getting rid of the "not one inch" rule might take some time.

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