REIT Credit Facilities—Real Estate Debt in an ERA of Capital Consolidation

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As the authors explain, real estate investment trust credit facilities are becoming an increasingly significant part of the commercial real estate lending market. In accommodating this demand, lenders and their counsel should be prepared to tackle both bank finance and real estate finance issues while simultaneously being mindful of the special needs of REIT borrowers and their businesses.

The low interest rate environment has been kind to real estate investment trusts (“REITs”). Using short-term, low rate financings, REITs have continued their quest to “corporatize” commercial real estate as the market has rebounded from the lows of 2008 and 2009. Investors seeking dividend yields have flocked to REITs, providing REITs with the equity capital necessary to fund significant growth. REIT IPOs are becoming particularly attractive, as evidenced by Paramount Group’s $2.3 billion IPO in November 2014, the largest REIT IPO yet. Capital is expected to continue to enter the market in 2015.¹

The popularity of REIT shares is due in large part to the advantages to investors of owning property through REITs, the tax benefits of which include the reduction or elimination of corporate tax, provided that the REIT meets certain Internal Revenue Code requirements. The Code requires that REITs distribute at least 90 percent of taxable income to shareholders,² which limits the ability of REITs to reinvest income, and as a result, these entities depend heavily on borrowed money for expansion. At times, the appetite of REITs for debt capital has seemed insatiable. Due to the growth of REITs and their borrowing demands, real estate lending to REITs will continue to grow. Particularly in the case of newly formed REITs and REITs that do not have sufficient credit ratings to issue bonds at favorable interest rates, corporate credit facilities will continue to be the principal source of financing for growth.

Many REITs have amended or replaced their credit facilities to achieve lower borrowing rates and increased extension options. Numerous REITs have supplemented their revolving credit facilities with sizeable term loans, many with tenors of as long as seven years. And in recent months, REITs have been engaging in significant merger and acquisition activity, with large-scale acquisitions often financed via bridge loan commitments provided by bank lenders. Significant

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REIT M&A activity is expected to continue in 2015. All of this adds up to an excellent market for REIT revolving credit facilities and term loans.

Issues arise in REIT lending that are not typical in either traditional mortgage lending or corporate financings because of the legal mandates that apply to REITs and influence the way they must conduct business and manage capital. REIT credit facilities combine aspects of traditional real estate finance and so-called bank finance because lenders underwrite both the general corporate credit of the borrower and the real estate assets it owns. Whether a facility is secured or unsecured, lenders must be sensitive to fundamental real estate underwriting norms as well as issues particular to the requirements of REITs. Although REITs may be publicly traded or privately held (and there is overlap in the issues that arise when lending to either type of REIT), this article focuses primarily on the financing of publicly-traded REITs.

A Growth Story

As with any other public company, as a REIT grows, its capital needs and ability to raise funds in different markets evolves. Upon the initial public offering of a REIT, lenders take a cautious approach and it is typical that the REIT’s only senior secured debt at that time will be a fully secured revolving credit facility. As the REIT’s credit improves, term loans may be added to accommodate acquisitions or development opportunities, and facilities may be amended to release collateral and loosen covenants. Once the senior debt of the REIT becomes investment grade rated, the REIT will typically want to take full advantage of the bond market. At that time, its senior bank credit facility may need to be amended to permit bonds as pari passu senior debt.

It is in the best interest of a REIT to maintain an unsecured (rather than secured) bank credit facility. This is because the interest rate on unsecured bonds issued by the REIT will be lower if such bonds rank pari passu with the REIT’s senior bank debt. Indeed, structurally subordinate bonds may not be marketable to bond investors at all. When originating a bank credit facility, lenders should bear in mind the potential for future bond issuances as the REIT grows.

Structuring the Credit Facility

Several matters should be considered by the parties when initially structuring the credit facility. First, depending on the borrower’s credit quality and financing needs, the facility will be structured either as secured (with collateral) or unsecured (no collateral). In either case, the REIT would be expected to identify a pool of assets that would support the financing, and the amount available to be borrowed would be based on a percentage of the value of the properties in the asset pool, all as determined by the lender through its underwriting process. In the case of a secured facility, the properties in the asset pool would be referred to as “borrowing base assets” and, in the case of an unsecured facility, the properties in the asset pool would be referred to as the “unencumbered assets.” (For simplicity, this article will refer to borrowing base assets and unencumbered assets as the “pooled assets.”) Lenders that lend against unencumbered assets typically require a negative pledge which ensures that the unencumbered pool of assets will not be pledged to secure other debt (with limited exceptions, such as capital leases). In the case of a secured facility, the lender should consider whether a cash management system should be implemented and whether any reserves, such as debt service or capital...
improvements reserves, should be required, in addition to mortgage liens on the pooled assets.

The exact identity of the borrower and any guarantors should be determined as early as possible in the course of the financing. Generally, the REIT’s operating partnership (often structured as a limited liability company) will be the borrower and the REIT and the subsidiaries that directly own or ground lease the pooled assets will be the guarantors. If the REIT has outstanding bonds, the bank lenders should seek guarantees from the same entities that are obligors in respect of the bonds, to ensure that the bonds and the credit facility are pari passu obligations of the REIT.

**Taxable REIT Subsidiaries**

Next, the parties should consider the treatment of taxable REIT subsidiaries (“TRSs”), particularly in the context of hotel companies or other REITs with other properties where a significant portion of the income from the pooled assets is not generated from tenant leases (i.e., where much of the REIT’s income is not “passive” rental income). Because the Internal Revenue Code distinguishes between “good” income, which is generally passive rental income and is counted toward the income tests applicable to REIT qualification under the Internal Revenue Code, and “bad” income, which may cause a REIT to flunk such income tests, a REIT that has any significant amount of bad income may lease its real estate to a TRS via an operating lease, following which the TRS will operate the property and pay rent (constituting “good” income) to the REIT. Because a TRS pays corporate-level income tax (which a REIT would not otherwise have to pay), it is in the REIT’s best interest to minimize taxable income at the TRS level. This is typically accomplished by setting the rent payable by the TRS under the operating lease at an amount that serves to eliminate most of the TRS’s taxable income.

For lenders to the REIT, however, the use of TRSs and operating leases in the organizational structure may raise complex issues. In the case of a secured credit facility, a lender will want each affiliate of the REIT that owns or leases a pooled asset to grant a mortgage covering such asset as collateral for the secured credit facility. This especially includes the TRS, which is the operator of the property and the entity through which cash flow from property operations flows. A corresponding guaranty from the TRS to the benefit of the lender would also typically be required. But federal income tax rules require that agreements between TRSs and REITs be on arms'-length terms, or else the TRS structure may not be respected for tax purposes, putting the REIT's continued qualification as a REIT at risk. Accordingly, accounting advisors generally recommend that a TRS which grants a mortgage or guaranty of its parent's corporate credit facility receive a “credit support fee” or similar payment from the REIT as compensation for its guaranty. This fee may be difficult to calculate with a high degree of confidence. Moreover, the fee would constitute taxable income to the TRS.

Faced with this scenario, a credit facility lender and a REIT borrower must balance the tax efficiency of the TRS structure against the lender’s desire for a comprehensive package of guarantees and collateral. In some secured credit facilities, lenders have become comfortable taking a pledge of equity interests in the TRS as collateral security rather than requiring that a mortgage and guaranty be granted by the TRS itself. These
kinds of structural compromises, however, tend to be less desirable in the context of an unsecured credit facility, because collateral cannot be granted to make up for other deficiencies in the structure without turning the facility from an unsecured facility to a secured one. And, as any REIT chief financial officer can attest, doing that may raise significant cost-of-credit considerations (the details of which are beyond the scope of this article).

**Subfacilities and Delayed Draw Facilities**

Other structuring issues that should be considered at an early stage are, in the case of a revolving credit facility, whether it will include sub-facilities for swing line borrowings (short term, same-day advances) and/or letters of credit and whether accommodation should be made for a possible future upsizing of the facility. If additional lending may be necessary (e.g., in the case of a near-term or pending assets acquisition), the parties should consider whether to include a delayed draw term loan. Such a term loan is advantageous to the borrower because the lenders are fully committed to fund. One possible disadvantage, however, is that after an initial grace period the borrower will be obligated to pay a “ticking fee” (an unused commitment fee) until the time the delayed draw term loan facility is drawn (or terminated). An alternative method of providing additional future lending is through an “accordion” feature, which permits the borrower to increase the facility to the extent the existing or new lenders are willing to extend additional credit at the time the accordion is exercised. While the inclusion of an accordion provision does not require the borrower to pay a fee prior to its exercise, it raises the reverse issue for the borrower because it is uncommitted. A borrower that anticipates needing more availability on its credit facility in the near term may be willing to pay a fee to avoid the risk of being unable to raise sufficient funds (or the risk that funds are available only at a prohibitively high rate).

**The Transition to Investment Grade**

Investment grade (“IG”) rated REITs generally benefit from credit facilities that are both unsecured and on terms more favorable to the borrower than can be obtained by non-IG rated companies. In the case of a non-IG rated REIT that anticipates obtaining an IG rating in the near future, features may be incorporated into the credit facility that anticipate the issuance of an IG rating. Such features may include subsidiary guarantor releases, an automatic repricing modification (to reduce the interest rate to reflect the better credit quality of the borrower) and certain covenant modifications. IG rated REITs are typically not required to include subsidiaries as guarantors of their credit facilities so long as they have not incurred other senior unsecured debt obligations supported by subsidiary guarantees. To that end, a credit agreement may provide that all subsidiary guarantors will be released as guarantors of the credit facility upon:

- the REIT obtaining an IG rating from S&P and Moody’s; and
- the release of all subsidiary guarantors as guarantors or borrowers under all other senior unsecured debt of the REIT, including any unsecured bonds.

The second item above is important because credit facility lenders will require that the REIT’s payment obligations on the credit facility be pari passu with all other senior unsecured debt of the REIT.
Another common feature to include in a credit facility intended to bridge the period during which a REIT transitions to an IG rating is a flexible pricing mechanism, whereby the REIT may elect to move from a leveraged-based pricing grid to a more attractive ratings-based pricing grid immediately upon achieving IG status. In other words, immediately upon receiving its IG rating, the REIT would have the right to start determining the margin at which interest accrues on the credit facility with reference to its debt rating, rather than with reference to its overall leverage ratio.

In addition to receiving more attractive pricing on their credit facilities, IG rated REITs are also typically subject to less restrictive covenants in their credit facilities than their non-IG rated cousins. While some borrowers may leave negotiating covenant changes for later, some credit agreements provide that certain affirmative and negative covenants automatically drop out upon the REIT becoming IG rated. The covenants that drop out may include, among others, the negative covenants on debt incurrence and asset sales, with the credit facility lenders relying on financial covenants to regulate these activities.

**Commitments—Fully Committed or Best Efforts**

The borrower and the administrative agent (or lead lender) would typically negotiate a term sheet and enter into a commitment letter and fee letter prior to negotiating definitive loan documents. Issues to consider at the commitment letter stage include:

- whether the commitment is “fully committed” or “best efforts”;
- negotiating material adverse change (or “MAC”) language;
- types and amounts of fees payable to the agent and the lenders; and
- compliance with “anti-tying” regulations.

The commitment letter (including the term sheet) will summarize the basic terms of the credit facility, and will address each of the matters mentioned above. In a “fully committed” financing, the lead lender generally agrees to provide the entire financing upon satisfaction of specified conditions precedent (including execution of final loan documents, the absence of a MAC, the completion of due diligence and the payment of fees). In a “best efforts” financing, the lead lender agrees to use commercially reasonable efforts to assemble a syndicate of lenders willing to provide lending commitments and often agrees to underwrite a portion of the facility if a minimum threshold of commitments from other lenders is obtained.

**MAC Language**

A highly negotiated part of the commitment letter is the MAC language, which gives the lender an opportunity to decline to lend if the circumstances of the lending market or the borrower change for the worse. Borrowers try to narrow these circumstances as much as possible because they want certainty of funds, while lenders try to keep them as broad as possible so that they can avoid making a bad loan. The so-called “business MAC” describes a change that materially adversely affects the REIT’s business. Typical language for this condition is “no event or condition having occurred or having become known that in the judgment of the lender has had or could reasonably be expected to have a material adverse effect on the business,
condition (financial or otherwise), prospects, operations or properties of the borrower and its subsidiaries.” Lenders pay particularly close attention to MAC language when lending to REITs because the credit of the REIT is just as important to the success of the transaction as the value of the pooled assets. Negotiated terms customarily include whether the lender’s judgment must be reasonable when determining whether a MAC has occurred (typically yes), whether the term “prospects” should be included as a factor in assessing adverse changes (typically no), and whether the loan parties and their assets should be considered on a consolidated rather than individual basis (typically yes, at least as to the loan parties).

The so-called “market MAC” describes a change that materially adversely affects the syndicated lending market. A common formulation for this condition is “no material disruption or material adverse change (or development that could reasonably be expected to result in a material adverse change) having occurred and continuing in or affecting the loan syndication or financial, banking or capital market conditions generally from those in effect on the date hereof that, individually or in the aggregate, in lender’s reasonable judgment could materially adversely affect lender’s ability to syndicate the facility.” This language potentially allows lenders to reopen negotiations or otherwise restructure a financing that cannot be successfully syndicated because market conditions have changed. Cross-border loans to REITs may also include a “country MAC” to provide for flexibility when adverse political or economic changes occur in the country at issue.

For all MAC provisions, borrowers with greater negotiating power (e.g., because markets are strong or the borrower has a high credit rating) will often succeed in narrowing the MAC clauses to limit any possible outs for the lenders. This is particularly true when the borrower has a specific need for funds to conduct a particular transaction (e.g., an acquisition financing), and certainty of funding is key to a successful closing.

**Lender Fees**

The fees payable to the lender are always a hot topic. The types and amounts of the fees as well as the times of payment will be agreed by the parties at the commitment stage of the financing. Fees, like interest rates, will generally be lower, on a percentage basis, for a highly rated borrower issuing debt that is easy to syndicate. Typical fees include arranger fees, upfront fees and, for a revolving credit facility, unused commitment fees. An arranger fee is paid to the agent or lead lender(s) for the structuring and syndication of the facility and is typically paid in full at closing based on the entire amount of the facility. An upfront fee is paid to the administrative agent for the benefit of each lender based on its committed loan amount. The upfront fee is often tiered so that lenders who offer greater commitments receive a higher percentage fee, although the fee is then paid by multiplying such percentage by each lender’s final allocated commitment on the closing date. Unused commitment fees are paid to lenders on revolving loans from and after the closing date to compensate them for the unused revolving loan commitments that remain available to be drawn by the borrower. The amount of the unused commitment fee is typically calculated quarterly based on the average daily unused revolving credit commitment. As described above, if there is a delayed draw term loan, the financing may include a ticking fee which is particu-
larly important to the lender if the parties understand that the borrower may ultimately access a less expensive source of capital (a bond issuance, for example) and thus may not draw on the commitment (and pay associated fees or interest) at the time the acquisition closing date arrives.

Anti-Tying Rules

When negotiating financing commitment papers and loan documents it is important for lenders to avoid violating the anti-tying laws. A prohibited tying arrangement is an agreement by one party (in this case, a bank) to sell a product on the condition that the customer (i.e., the borrower) also purchase (or agree not to purchase from a different seller) a different product. In the context of lending transactions, banks can be expected to consider the profitability of the bank’s overall relationship with the borrower in deciding whether to extend credit and how to price a particular transaction. In practice, anti-tying concerns may arise when the borrower needs underwriting services for a bond or equity issuance as well as a credit facility. In such cases, the anti-tying rules would prohibit the bank from conditioning availability of its loan commitment on obtaining a related (and possibly more lucrative) capital markets underwriting engagement. Another situation that could result in an anti-tying violation arises when a lender’s commitment letter includes a “most favored nation” clause requiring the borrower to give the committing lender equal treatment under any more favorable terms that the borrower may offer to other lenders to encourage them to participate in the credit facility. This obligation could indirectly lead to a tying problem if a new lender that is not subject to the anti-tying rules (e.g., a non-bank) commits to the financing on the condition that such new lender be given a lucrative role by the borrower in a capital markets transaction. While such an arrangement would be a prohibited tie if entered into by a bank, a non-bank is not subject to such tying restrictions. Thus, prudent bank lenders would be well advised to include an exception for impermissible tying in their most favored nation clauses.

Loan Documents

Once the parties turn to negotiating the loan documents, there are certain provisions common to REIT financings which merit discussion. These include the treatment of borrowing base assets (or, in an unsecured transaction, “unencumbered properties”), the breadth of the representations and covenants, the nature of the financial covenants and the need to accommodate the REIT’s ability to pay dividends. Each of these topics is discussed below.

Underwritten Asset Criteria

As discussed above, borrowing availability under REIT credit facilities is generally based on a percentage of the value of the “borrowing base assets” (“BBAs”), which typically consist of fully operating real property assets of the REIT. While borrowing base assets for companies in other industries may include inventory and accounts receivable, borrowing base assets for REITs consist only of real property assets (which, depending on the borrower’s business, may be office buildings, multi-family housing, shopping malls, industrial properties, hotels, storage units, data centers or other types of income producing real estate) and therefore raise issues that are unique to real property. Such issues include the need for lenders to evaluate items such as appraisals, title work, land surveys, zoning reports and rent rolls. Moreover, for a secured financing, the lenders should con-
sider topics such as the most appropriate and tax-efficient form of security instrument in each jurisdiction where collateral properties are located. In cross-border and multi-state secured financings, local law advice will be necessary and should be obtained early in the process of structuring the loan.

Whether a REIT credit facility is secured or unsecured (we will refer to pooled assets in a secured transaction as “borrowing base assets” or “BBAs” and in an unsecured transaction as “unencumbered assets” or “UPAs”), the assets at issue must meet certain requirements set forth in the loan documents. Typical requirements for each such asset are that it:

(a) is wholly-owned in fee simple or subject to ground leases meeting certain qualifications,

(b) is income producing,

(c) has no title, survey, environmental, structural or other defects that would give rise to a material adverse effect on its value,

(d) is unencumbered, is not subject to any negative pledge and none of the equity interests in any entity that directly or indirectly owns such asset is pledged to another lender,

(e) is located in the US (or other relevant jurisdiction) and

(f) is owned directly by the borrower or a guarantor.

The credit agreement may also require a minimum number of BBAs or UPAs and may specify other diversification requirements applicable to the asset pool depending on the specific business and holdings of the REIT. The credit facilities will often permit the REIT to move assets in and out of the borrowing base or unencumbered asset pool if certain conditions are met or the requisite lender approvals for such action (as specified in the loan documentation) are given.

**Treatment of Subsidiaries**

Another issue to be considered and negotiated is which subsidiaries of the REIT should be subject to the representations and covenants in the loan documents. Because the lenders are looking to the credit of the REIT as a whole, credit agreements will, as a starting point, include representations and covenants that cover the REIT and all of its subsidiaries. However, borrowers with strong credit ratings may push back on this requirement, and loan documents would typically allow for subsidiaries that are not in the chain of ownership of the BBAs to conduct their contemplated businesses without interference by the lenders, including by allowing such subsidiaries of the REIT to incur non-recourse mortgage debt secured by non-BBAs. Even in this scenario, however, representations and information covenants generally remain quite broad, because the lenders will require information about the entire business of the REIT, because they are relying in large part on the overall credit of the entire enterprise.

**Financial Covenants Generally**

A key element of REIT credit facility documentation is the financial covenants. These covenants are designed to measure the health of the entire company as well as the BBAs or UPAs because the lenders are looking both to the value of the underwritten assets and the credit of the REIT. Therefore, REIT credit facilities (in contrast to traditional mortgage loan agreements) typically contain two sets of financial covenants. One set tests financial strength relating to the pool of
underwritten assets while a second set tests financial strength relating to the REIT and its subsidiaries on a consolidated basis. The emphasis of the financial covenants is on cash flow, leverage, EBITDA and net worth and the covenants are tested quarterly based on the REIT’s financial statements.

The most typical financial covenants that relate to underwritten assets are:

(i) leverage ratio tests, which measure whether the value of a REIT’s assets is sufficient to satisfy debt,
(ii) interest or debt service coverage ratios, which measure whether net operating income is sufficient to cover interest payments, and
(iii) debt yield tests, which measure whether net operating income is sufficient to cover debt payments (these have recently become more common than debt service coverage ratio tests, although they serve the same purpose).

Financial Covenants for Secured vs. Unsecured Asset Pools

The formulation of each such test differs depending on whether the facility is secured or unsecured. In a secured transaction, the lenders will be interested in measuring leverage ratios, debt yield and interest coverage ratios in relation to the facility and the BBAs, because the lenders hold first priority liens on the BBAs and can depend on those assets for repayment. Therefore, in a secured credit facility,

(i) the maximum borrowing base leverage ratio compares exposure under the facility to the value of the BBAs,
(ii) the minimum borrowing base debt yield test compares net operating income of the BBAs to the amount of debt outstanding under the facility, and
(iii) the minimum borrowing base interest coverage ratio compares net operating income of the BBAs to interest expense attributable solely to the facility.

In an unsecured transaction, however, the lenders will be concerned about all unsecured debt of the REIT because (assuming identical obligor groups) all other senior unsecured creditors will have access to the UPAs on a pari passu basis with the credit facility lenders. Therefore, in an unsecured facility,

(i) the maximum unsecured leverage ratio compares all senior unsecured debt of the REIT and its subsidiaries to the value of the UPAs,
(ii) the minimum unsecured debt yield test compares net operating income of the UPAs to all senior unsecured debt of the REIT and its subsidiaries, and
(iii) the minimum unsecured interest coverage ratio compares net operating income of the UPAs to all interest expense attributable to senior unsecured debt of the REIT and its subsidiaries.

REIT Level Financial Covenants

Typical financial covenants that relate to the entire REIT are the following:

- a leverage ratio, which compares the debt of the REIT and its subsidiaries to the value of all of the assets of the REIT and its subsidiaries;
- a secured leverage ratio, which compares the secured debt of the REIT and its subsidiaries to the value of all assets of the REIT and its subsidiaries;
- a fixed charge coverage ratio, which compares the EBITDA of the REIT and its subsidiaries to the sum of interest and scheduled principal amortization
payable on debt and cash dividends payable on preferred equity;

- an interest coverage ratio, which compares the EBITDA of the REIT and its subsidiaries to the interest expense attributable to all debt of the REIT and its subsidiaries;

- a minimum tangible net worth test, which is usually computed as 75% of tangible net worth at closing plus 75% of the net proceeds of any equity issuances conducted after the closing date; and

- a dividend payout ratio test, which limits the amount of distributions that may be made by the REIT to its shareholders to the amount necessary to maintain REIT status and avoid imposition of income and excise taxes under the U.S. Tax Code.

Other REIT Specific Covenants

Other loan covenants particular to REIT facilities include limitations on overall REIT investments (generally limited by investment type to a fixed percentage of the REIT’s total asset value), so that the REIT may only invest up to a specified limit in riskier assets such as joint ventures, loans, unimproved land and development and redevelopment properties, and covenants requiring the REIT to remain qualified as a real estate investment trust under the Internal Revenue Code and, in the case of a publicly held REIT, its listing as a public company. When drafting and negotiating covenants in credit agreements, it is important to keep in mind that REITs generally follow business plans that target fast growth. As a consequence, the REIT may need flexibility to accommodate its growth. For example, will the REIT need to issue other unsecured senior debt? If so, the lenders should ensure that the debt, lien and negative pledge covenants of the credit agreement are crafted to permit the issuance of such additional debt without the need for future amendments or waivers, which could cause uncomfortable delays in the closing of later transactions.

Conclusion

REIT credit facilities are becoming an increasingly significant part of the commercial real estate lending market. In accommodating this demand, lenders and their counsel should be prepared to tackle both bank finance and real estate finance issues while simultaneously being mindful of the special needs of REIT borrowers and their businesses. Careful consideration of each of the matters addressed in this article is crucial to developing and documenting loan structures that will properly serve the interests of both REITs and their lenders.

NOTES:


2See I.R.C. § 857(a).


4The value of the asset for underwriting purposes is generally based on its net operating income, appraised value or book value.

5See, e.g., I.R.C. §§ 856(c)(2) (acceptable sources of gross income), 856(d)(2) (exclusions from acceptable rental income) and 857(b)(7) (taxation of REITs—100% taxation of redetermined rents).

6See, e.g., I.R.C. §§ 856(d)(8) (special rule for TRSs) and 857(b)(7) (taxation of REITs—100% taxation of redetermined rents).

7Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972) does not apply to the nonbank affiliates of banks or other nonbank entities. Banks and their nonbank affiliates, however, are subject to the anti-tying restrictions contained in federal antitrust laws.