Tax Issues associated with Tax Exempt Entities and REITs as owners of Real Estate

Session 9

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Overview

- Introduction – the players
- Tax-exempts as direct owners of real estate or indirect owners through partnerships
- REITs as direct owners of real estate or indirect owners through partnerships
- Example: partnership with REIT and tax-exempt partners

The Players

- Tax Exempt Investors
  - Pension plans
  - Endowments
  - Traditional §501(c)(3) charitable organizations

- REITs
  - Public REITs in JVs with operating partners
  - Private REITs

Tax-Exempts as direct owners of real estate

- Exemption considerations
- Unrelated Trade or Business Income
  - Unrelated trade or business that is regularly carried on
  - Dealer property
  - Rents: customary services only
  - Payments from controlled entities
  - Certain debt-financed income

Tax-Exempts owning real estate through partnerships

- Per-se UBTI income: active trade or business such as condos
- Fractions rule if debt-financed income and not per-se UBTI
  - Liquidate with capital accounts (substantial economic effect safe harbors)
  - Fractions rule percentage (TE's highest income cannot exceed lowest loss)
  - Reasonable preferred returns

REITs as direct owners of real estate

- Prohibited Transaction Income
- “Good” Income/Assets
- “Bad” Income/Assets

Benefits of REITs

- ❑ Minimize or avoid corporate "double tax"
- ❑ Avoid Unrelated Business Income Tax ("UBIT")
- ❑ Avoid U.S. tax under Foreign Investment in Real Property Tax Act ("FIRPTA") rules
- ❑ Simplify tax reporting.

Economic Limitations of REITs

- Cash flow limitations:
  - Must pay out 90% of income to qualify as a REIT
  - generally pay out 100% of income and gain to avoid REIT level income tax
- Investment limitations
  - Asset limitations: 75% test, 25% test, 5% test and 10% test
  - General Income Limitations:
    - 95% from specified real estate income and specified passive income
    - 75% from specified real estate income and temporary investments
  - Prohibited Transactions: 100% tax on "dealer" income

Qualified REIT Subsidiaries

- Qualified REIT Subsidiary (QRS)
  - Includes 100% subsidiaries that are not Taxable REIT Subsidiaries (TRS)
  - QRS is effectively disregarded for tax purposes

REITs owning through Partnerships

- For purposes of the Income and Asset tests, REIT is deemed to own its proportionate share of the assets and income of any partnership (based on capital)

- Partnership assets and income retain character at REIT level for purposes of REIT income and asset tests

Taxable REIT subsidiaries (TRS)

- TRS Benefits
  - Allows a REIT to economically benefit from “bad” REIT income/assets, subject to corporate tax at the TRS level
  - TRS can generally undertake third-party management, and development and sales activities, and activities not related to real estate
- TRS Limitations
  - TRS securities generally can not collectively represent more than 25% of REIT assets
  - TRS cannot operate/manage lodging or health care facility

Investor Taxes – Taxable Shareholders

- **Dividend income**. Distributions to REIT shareholders are generally treated as dividends
  - Capital gain dividends
  - Ordinary dividends
  - Return of capital
- **No DRD**. No portion of any REIT dividends is eligible for the dividends received deduction for corporate shareholders, and corporate shareholders may be required to treat up to 20% of any capital gain dividend as ordinary income

Investor Taxes – Tax-Exempt Shareholders

- **Generally not UBTI**
  - REIT level financing. Rev. Rul. 66-106 held that dividend income to tax-exempt REIT shareholder is not UBTI even with acquisition debt at REIT level
  - Shareholder level financing. May still create UBTI from debt-financed income

- **Exception for pension-held REITs**. Tax-exempt pension trusts (including §401(k) but excluding IRA), which own more than 10% by value of a "pension-held REIT" at any time during a taxable year may be required to treat a percentage of all dividends received from the pension-held REIT during the year as unrelated business taxable income

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Example

- Developer (D), Tax-Exempt (TE), and REIT form JV

- D contributes services, TE and REIT each contribute $50M for preferred interests

- JV Project: Mixed use condo, office, and hotel

Profit and Loss sharing

- General Profits:
  - 18% preferred return on capital to TE and REIT
  - Residual 50% to D, 25% each to TE and REIT
- Losses: 100% to D
- UBTI/Dealer income: 100% to D

Variables

- Possible contribution of D’s special-services management company
- Hotel directly held and operated vs. master lease
- D desires targeted allocations with cash waterfall liquidation

Issues

- Impact of condos?
- Impact of hotel?
- Reasonable preferred return?
- Loss allocations?
- Management company income?
- Target allocations impact?
- Subordination of D’s capital?

Possible Solutions

- Blocker corporations
- Loan vs. capital contribution
- Taxable REIT Subsidiaries
- Liquidation based on capital accounts
- Combined investment

For further information

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