



# Accessing International Equity: A Primer on Private REITs in the Hotel Industry

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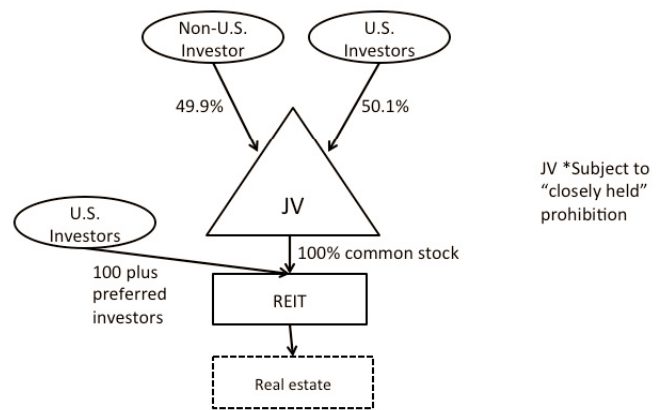
With international investors showing strong interest in making joint venture investments in US hotels, understanding their tax challenges and developing an efficient tax structure provides US hotel owners with a competitive advantage in accessing a large equity capital source over standard limited liability company or corporate structures. One efficient tax structure often used for an international joint venture investment in a US hotel is a private real estate investment trust (“Private REIT”) and a potentially even more efficient tax structure for such an investment is a “domestically controlled” Private REIT.<sup>1</sup>

Tax structuring is imperative for international investment in a US hotel. Although perhaps the most simple tax structure is to own the US hotel through a leveraged C corporation, that structure has the potential cost of two levels of tax on the hotel’s net profits.<sup>2</sup> A Private REIT, by contrast, only has a single shareholder-level of ordinary dividend tax because the REIT itself receives a dividends paid deduction.<sup>3</sup>

The default shareholder dividend tax rate is 30 percent. Although treaties can reduce this rate, many treaty reductions are inapplicable to REIT dividends. Further, treaty reductions do not typically apply to capital gain dividends (so called “FIRPTA gain”), such as the gain that passes through when the Private REIT sells the underlying real estate. This capital gain tax is 35 percent for corporate investors and 20 percent<sup>4</sup> for individuals, plus the potential for an additional 30 percent “branch profits tax” for corporate investors (often reduced to 5 percent under treaty).

In order to minimize these taxes to the extent possible, an international investor often will insist on owning less than 50 percent of the REIT, with most demanding further that the other owners be US persons so that the REIT is domestically controlled.<sup>5</sup> All international investors avoid the significant FIRPTA gain tax on capital gains if they can sell stock in a domestically controlled REIT. Moreover, sovereign wealth funds, such as governmental

pension plans, may be able to also avoid US income tax on ordinary REIT dividends under a special governmental exception which only applies if the governmental entity does not have effective practical control of the REIT. Below is a chart showing how a domestically controlled Private REIT can be used as a REIT blocker.



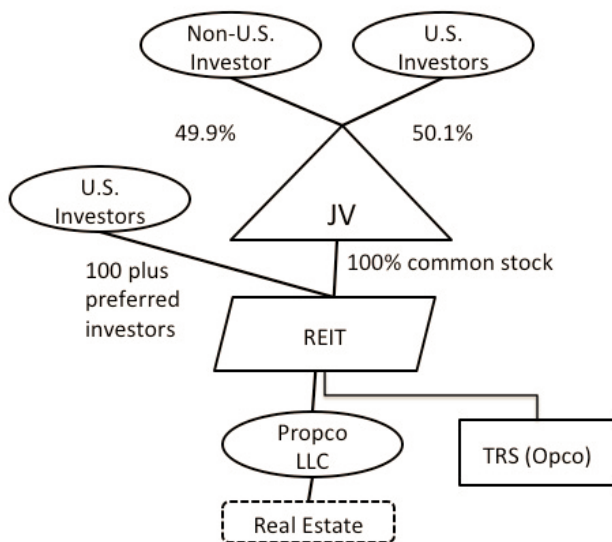
Interestingly, a Private REIT cannot be used for investments in most operating companies because the income from such companies is considered “bad” income for a REIT. However, the Internal Revenue Code has a special rule that permits the use of a “master-lease” structure for a hotel to cleanse much of the income from its operations by converting it to rental income. This same rule is used by publicly traded US hotel REITs. Thus, the Private REIT structure provides a special tax advantage for a foreign investment in a US hotel and this advantage is even more powerful when the foreign investor holds a minority investment in a US hotel through a domestically controlled Private REIT.

## A Primer on Private REITs and Their Structure in the Hotel Industry

In order to qualify as a REIT, a company must meet several specific IRS tests, including that 75 percent of its income must come from rents from real property, interest on real property, or the sale of real property.



Income from other sources is considered bad income for purposes of this test. Because room revenue and most other income from operations of a hotel is bad income for a REIT, a master-lease structure is generally used in which the Private REIT or a pass-through entity owned by the Private REIT leases the hotel to a similarly owned operating tenant. This is often referred to as the “Propco-Opco” structure. In this structure, the hotel and related land are owned by the Private REIT or a pass-through entity below the Private REIT. The operations side will be held directly or indirectly (through a pass-through entity) by a taxable entity (i.e., a “taxable REIT subsidiary” or “TRS”). The TRS is, in turn, owned by the Private REIT. The diagram below depicts an overview of a hotel Propco-Opco structure.



The Propco-Opco structure has its complications, many of which are required to deal with the tax rules. These can be broken down as follows:

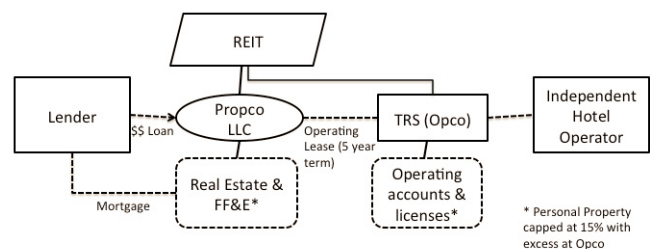
*Split of Assets between Propco and Opco.* Operating accounts and licenses are held by the TRS. Franchise agreements are made by the TRS but usually require a guarantee by the Private REIT or Propco LLC. The hotel’s furniture, fixtures and equipment (“FF&E”) is usually owned by the Private REIT except to the extent the fair market value of the FF&E and other personal property at the hotel exceeds the portion that the IRS allows to not taint the treatment of rents as being real property rents. Generally, the IRS requires that no more than 15 percent of the rent payable by the operating tenant be attributable

to FF&E and other personal property leased by the Private REIT to the TRS. So, to the extent the fair market rental value of the FF&E and other property exceed this limit, it should be owned by the TRS (or leased by the TRS from someone other than the Private REIT).

*Contracts between Private REIT and the TRS.* The Private REIT or Propco LLC enters to an operating lease with the TRS using market lease terms. The rent is generally measured with a fixed base rent plus a percentage of gross revenues. The lease cannot have rent based on net income for tax reasons. The most common lease term is 3–5 years, although shorter terms can be subject to concerns that frequently resetting the lease rent in an attempt to minimize the TRS’ net income creates more risk that the rent is treated as based on the TRS’ net income.

*Contracts between the TRS and Third Parties.* The TRS then enters a hotel management agreement with an independent hotel operator to run the hotel. The TRS has all revenue and expenses from operations of the hotel and hopefully has enough income to achieve a reasonable arms length profit (or “leakage” as this amount is sometimes referred to in the industry).

*Financing Structure.* The Private REIT or Propco LLC would be the borrower on the third-party financing and would provide the mortgage. Lenders will typically want some indirect access to the assets on the TRS side, although a direct TRS guarantee of the mortgage debt generally should be avoided. One structure sometimes used is for the TRS to pledge its assets to the landlord under the master lease of the hotel to support the TRS’ obligations under the master lease, with the landlord further assigning both the pledge and the master lease to its mortgage lender.





## Creating a Private REIT Structure for a Hotel

Parties considering a Private REIT in the hotel industry will need to make decisions on several structural points, including limitations on how assets (such as FF&E) are held; whether subleases are allowed and if so, what amount of sublease rental income is allowable; terms of the master lease, rent amounts and termination fees. In addition, there are specific considerations with regard to whether a single owner entity and operating tenant may be used for multiple properties which may consolidate operating losses and thus create a more favorable tax situation.

Establishing and negotiating a hotel Private REIT that works for all parties involved is complicated. Interested parties should recruit a seasoned group of legal, tax, and financial advisors in order to achieve the desired outcome. Steps in the process include forming the Private REIT/operating tenant structure; purchasing and financing of the property; entering into a lease with the operating tenant; and structuring the management contract with an independent contractor.

Private REITs are attractive to foreign investors but they are not without downsides. Interested parties should be aware there is no Section 1031 deferral on gain on the sale of REIT stock; owners incur the possibility of a TRS tax on the income of the operating tenant and there are REIT compliance costs, including a requirement that the REIT have and maintain at least 100 shareholders,

which is generally satisfied through a private placement with a specialty company that organizes preferred REIT shareholders. If the REIT fails, there are also potential corporate taxes the owner will incur.

A Private REIT can be of great value in attracting international capital because of its attractive tax structure. However, it is not the only investment scenario available for hotel sponsors seeking to attract foreign capital. Interested hotel sponsors should work with their tax, legal and real estate advisors to determine the best avenues for attracting foreign investments. ★

1. For more information on investing through domestically controlled REITs see *AFIRE News*, Grumbacher, Towsner, and Schneider, *A Three-Part Primer on Using Private REITs for Institutional Co-Investment with Sovereign Wealth Funds in US Real Estate* (March/April, May/June and July/August 2012 editions).
2. See *AFIRE News*, Schneider, Grumbacher, and Towsner, *Developing a Tax Strategy to Invest in US Real Estate* (Summer 2013 edition). Note that treaties often greatly reduce the second level of dividend tax on non-capital gain "FIRPTA" dividends. Further, single-property blocker corporations can often avoid the second level of FIRPTA tax by having the C corporation first sell the underlying real property prior to liquidating the corporation.
3. Because a hotel REIT will need to sever the operations and property side of the business, the operations side will be subject to a corporate-level tax through a Taxable REIT Subsidiary ("TRS"). Also, because of the "captive REIT" tax in some states, additional state taxes may apply in certain cases.
4. For many individuals over the income threshold, an additional 3.8 percent Medicare tax applies to net investment income.
5. A Private REIT would be considered to be domestically controlled if less than 50 percent of the fair market value of its outstanding stock is held by foreign persons during the IRS' measurement period.



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