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Why Private Investment Funds Are Using REITs to Invest in Real Estate

by Michael Bolotin

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In this report, Bolotin explains why and how private investment funds use real estate investment trusts in their investment structures, and he explores several issues unique to private REITs.

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Table of Contents

I. Introduction 1087
II. Structure Generally 1087
III. Background of the REIT Rules 1088
IV. Why Funds Use REITs 1089
A. Ordinary Dividends 1090
B. Capital Gain Dividends 1091
C. Gain From Sale of REIT Shares 1091
D. Use of REITs to Originate Mortgage Debt 1093
E. Foreign Investors — A Summary . . . 1094
V. Tax-Exempt Investors 1094
VI. Issues Faced by REITs Owned by Funds 1095
A. Related-Party Rents 1095
B. Dividends Paid Deduction 1097
C. Private REIT Management 1100
VII. Conclusion 1101

I. Introduction

This report considers how and why private investment funds use real estate investment trusts in making investments. It explores the benefits for foreign and tax-exempt investors in making both equity and debt investments through private REITs and examines several issues unique to private REITs, including preferential dividends, the problem of related-party rents, and management.

II. Structure Generally

While a fund could structure its real estate investments using REITs in many different ways, this report assumes a relatively straightforward structure as follows: The fund itself is structured as a Delaware partnership and treated as a partnership for federal income tax purposes.[1] It has several partners, including a general partner that, together with its affiliates, manages the fund and receives a percentage of fund profits (a carried interest) and an asset management fee based on a percentage of the fund's capital commitments or assets. The fund has limited partners of varying size, including U.S. taxable corporations and individuals; U.S. corporate pension plans, state pension plans, and other tax-exempt entities; and foreign investors, including both foreign sovereigns and foreign pension plans that qualify for the benefits of section 897(l) (qualified foreign pension funds (QFPFs)). The fund then forms a REIT in which the fund owns all the common

[1]Funds investing in U.S. real estate are generally organized in the United States to avoid withholding under section 1445 on dispositions of U.S. real property.

equity, which it uses to make real estate investments. Depending on the fund's investment strategy and investor base, it may use a single REIT to make multiple investments or may use a new REIT for each investment. The fund exits investments either by selling REIT shares or by having the REIT sell real property and distribute the proceeds to the fund.

III. Background of the REIT Rules

The REIT rules were designed for investors seeking a tax-efficient way to pool capital. Before 1935, many investors used a business trust to receive flow-through taxation, rather than an association that was taxed at the entity level as well as at the shareholder level. However, in 1935 the Supreme Court put an end to the structure. In *Morrissey*,[2] the Court held that a business trust was an association and therefore subject to double taxation. Case law before *Morrissey* hinged on whether the shareholders of the business trust could control the trustees or the management of the business, among other factors.[3] Based on those cases, Treasury then wrote regulations moving toward a functional, rather than formalistic, approach to entity classification.[4] Completing the evolution, the Court took a functional approach in *Morrissey* and looked past the labeling of entities. The Court examined several factors to determine whether there was an association, including (1) centralized management, (2) continuity of life, (3) limited liability for beneficiaries and management, and (4) the transferability of ownership. Because the trust in *Morrissey* contained all four elements, the Court found that it was an association.

Congress passed the original REIT rules in 1960.[5] The drafters aimed to open up real estate investment to the everyday investor; before then, Congress viewed real estate investment as available only to wealthy individuals, because they could afford to own real estate directly.[6] As originally envisioned, a REIT would pool capital from numerous investors rather than a select few. Although the REIT rules never required the REIT to be publicly traded, Congress envisioned lay investors pushing capital into the real estate market with relative ease through REITs. REITs were required to have at least 100 shareholders. Other formalistic rules were designed to create fungible REIT securities and give smaller investors the benefits of risk diversification, expert investment counsel, and access to larger projects that they could not achieve on their own.[7]

Congress wanted private, rather than government, capital injections into the real estate market. Beginning in the 1930s, the federal government played a direct and central role in the home mortgage market. For example, the Veterans Administration and the Federal Housing Administration subsidized home mortgages through government guarantees and insurance.[8] Congress in 1960 wanted to move away from a mortgage market dependent on the federal government toward one built on private capital, at least more so than in the prior decades.[9] Hence, Congress drafted the REIT rules as tax relief for private real estate investment, hoping to spur on the capital influx it wanted.

Congress also tried to draw a sharp line between what it saw as passive investment and the active operation of business, with a REIT engaging only in the former.[10] It did not want to provide a dividends paid deduction to operatory companies to the detriment of companies organized as traditional corporations. Indeed, many of the rules in the code try to ensure that a REIT earns passive income rather than income from an active business.[11]

The REIT rules were passed 37 years before the check-the-box regulations became effective, so it comes as no surprise that the original rules hewed closely to the factors the Supreme Court used to determine association status in *Morrissey*. Those factors include centralized management,

[2] *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

[3] *Id.* at 350-353.

[4] *Id.* at 353-354.

[5] P.L. 86-779.

[6] H.R. Rep. No. 86-2020, at 3 (1960).

[7] *Id.* at 3-4.

[8] Daniel K. Fetter, "The Twentieth-Century Increase in U.S. Home Ownership: Facts and Hypotheses," in *Housing and Mortgage Markets in Historical Perspective* 346 (2014).

[9] H.R. Rep. No. 86-2020, at 4 (1960).

[10] *Id.*

[11] *Id.*

transferability of interests, continuity of life, and limited liability. This system assured that any unincorporated trust wishing to garner passthrough taxation would need to follow the strict REIT rules.

Echoing the requirements of *Morrissey*, the original REIT rules required that (1) the trust be managed by trustees, (2) there be transferable shares of beneficial ownership, (3) but for the rules, the trust would be taxable as an association, (4) property not be held primarily for sale to customers in the ordinary course of the REIT's trade or business, (5) there be 100 or more beneficial owners, and (6) no five individuals directly or indirectly own more than 50 percent of the trust.[12]

The rules required the REIT to distribute at least 90 percent of its REIT taxable income.[13] A REIT could not provide non-customary services except through an independent contractor, and it could not receive any income from that contractor. Under the rules, an independent contractor could own no more than 35 percent of the REIT.[14] Similar to the regulated investment company rules, Congress created income and asset tests in the REIT rules. The income test contained two tiers. First, at least 90 percent of gross income (now 95 percent) had to be from passive sources like dividends, interests, and rents from real property. The second tier required a REIT to derive at least 75 percent of its gross income from rents from real property, among other passive sources of income from real estate.

Legislation enacted since the passage of the REIT rules has moved the scheme away from some of the policy positions Congress staked in 1960. However, the core of the policy remains. This has created issues over the years as funds try to shoehorn private REITs into the REIT rules, even though the rules were generally contemplated for more widely held public or quasi-public companies. Rather than using a REIT to concentrate multiple investors, funds concentrate investors at the partnership level and then use REITs to make investments. Moreover, although the entity classification issues that caused Congress to require REITs to fit within the *Morrissey* test for treatment as an association no longer serve a meaningful substantive purpose after adoption of the check-the-box regulations, they were never removed from the code and therefore still apply to REITs formed today.

IV. Why Funds Use REITs

An analysis of the use of REITs by funds would be incomplete without considering why a fund would use them. Although REITs may provide some benefits to U.S. individual investors in a fund by blocking state tax filings, the principal reasons that funds use REITs rather than invest in U.S. real estate in partnership or other flow-through form is for the benefit of their foreign and tax-exempt investors.

REITs provide a particularly tax-efficient solution for the tax issues faced by foreigners when investing in U.S. real property. This section of the report examines why funds use REITs for the benefit of foreign investors, how various types of foreign investors (including pension funds, governmental entities, and treaty-eligible investors) are taxed on different forms of income from REITs, and how that affects the manner in which a fund will invest in and exit out of U.S. real property. Finally, it considers the use of REITs as a solution for the issues faced by foreign investors in funds that originate debt secured by real property.

The key advantage of investing through a REIT as compared with investing in U.S. real property in a flow-through form is that a REIT protects foreign investors from recognizing effectively connected income as a result of the operation of the real property and associated activities.[15] If a fund were to invest in U.S. real property directly or through partnerships or other tax-transparent entities, the activities arising from that investment would generally cause the fund and its foreign partners to be treated as engaged in a U.S. trade or business.[16] This would require foreign partners in the fund to pay federal income

[12] Section 856(a) (1960).

[13] Section 857(a) (1960).

[14] Section 856(d) (1960).

[15] As discussed later, transactions involving sales of real property held by a REIT or sales of REIT shares may generate ECI under the 1980 Foreign Investment in Real Property Tax Act rules.

[16] Section 875.

tax (and for foreign corporate partners, branch profits tax) on current income generated from U.S. real property investments and to file federal income tax returns.[17] On the other hand, if the fund interposes a REIT between itself and the U.S. real property, the REIT, as a corporation, blocks the attribution of the trade or business to the fund and its foreign partners.

A REIT owned by a fund will generate three principal sources of income. First are dividends paid by a REIT, other than those attributable to gains from sales or exchanges of U.S. real property interests (ordinary dividends). Second are dividends paid by the REIT that are attributable to gains from sales or exchanges of U.S. real property interests by the REIT (capital gain dividends). The third is gain from the sale of REIT shares. The following breaks down the treatment of each type of income for various types of foreign investors.

A. Ordinary Dividends

Ordinary dividends, which generally consist of rent, interest, or similar non-capital-gain income of a REIT, are treated as fixed or determinable annual or periodic income and therefore generally subject to withholding at a 30 percent rate when allocated by a fund to a foreign investor.[18] However, this withholding may be reduced or eliminated for various reasons.

A foreign investor that qualifies for the benefits of an income tax treaty with the United States may have its withholding on ordinary dividends reduced in accordance with the treaty. Because REITs generally will operate to eliminate their federal corporate income tax burden, withholding is the only federal income tax imposed on ordinary dividends received by foreign investors. As a result, although some treaties provide a reduced rate for REIT dividends generally, a foreign investor seeking to qualify for the reduced rate might have to meet various conditions that would not be required to qualify for a reduced rate on dividends from a non-REIT C corporation, and some lower withholding rates may be unavailable for REIT ordinary dividends.[19] However, some treaties provide that a treaty-qualifying pension fund can receive ordinary REIT dividends without any U.S. withholding.[20]

Separate from any treaty, foreign governmental investors can qualify for a complete elimination of withholding on ordinary dividends from a REIT as long as the governmental entity does not control the REIT.[21] However, because ordinary dividends are taxable under section 1441 as FDAP, rather than as effectively connected with a U.S. trade or business under the 1980 Foreign Investment in Real Property Tax Act, a QFPF that qualifies for an exemption from FIRPTA under section 897(1) still bears withholding on ordinary REIT dividends unless another exemption applies.

A fund that has a large number of foreign investors (especially foreign investors that don't qualify for the benefits of any U.S. tax treaty or section 892) may seek to limit the amount of ordinary dividends paid by the REIT to the fund in order to limit withholding. However, because a REIT generally is required to distribute out at least 90 percent of its taxable income annually,[22] retaining taxable income at the REIT is not an option.

One way to reduce ordinary dividends while maintaining REIT status is for the fund to capitalize the REIT in part with debt and in part with equity. If properly structured, the debt should generate deductible interest, which will allow the REIT to reduce its taxable income and therefore reduce the amount of ordinary dividends it is required to pay each year. Although the interest is also FDAP and subject to 30 percent withholding, interest is generally subject to much more favorable withholding treatment than ordinary dividends. Under the portfolio interest exemption, a foreign investor that indirectly owns less than 10 percent of the

[17] A failure to file a U.S. federal income tax return for a non-U.S. investor with ECI generally results in deductions being disallowed and a tolling of the statute of limitations. Sections 874(a) and 882(c)(2).

[18] Section 1441.

[19] *See* Sweden-U.S. treaty, art. 10(4)(a); France-U.S. treaty, art. 10(5)(b); and Belgium-U.S. treaty, art. 10(6)(a).

[20] *See* Canada-U.S. treaty, Art. XVIII(1); and Netherlands-U.S. treaty, art. 35(1).

[21] Section 892.

[22] Section 857(a)(1).

voting stock of the REIT will be exempt from withholding on its share of most non-contingent interest.[23] This is true even if the investor owns REIT shares through a fund that owns more than 10 percent of the REIT's voting stock. Moreover, for treaty-eligible investors, many U.S. tax treaties eliminate withholding on interest or reduce the withholding rate to 10 percent, while, as discussed earlier, ordinary REIT dividends may not benefit from such a generous rate reduction.

By capitalizing a REIT in part with debt, a fund can convert ordinary dividends, which often suffer from a higher rate of U.S. withholding, into interest income that is much more likely to qualify for a complete exemption from U.S. withholding tax. To be effective, however, the debt must generate tax-deductible interest expense. Although REITs are exempt from the interest disallowance rules of section 163(j),[24] other rules (such as those governing applicable high-yield discount obligations) may reduce or eliminate the deduction for interest on debt.[25] Similarly, great care should be taken to ensure that any shareholder debt is respected as debt for tax purposes rather than recast as equity.

B. Capital Gain Dividends

Capital gain dividends are subject to an unusual treatment for federal income tax purposes because they retain their character as gain from the sale or exchange of U.S. real property in the hands of investors.[26] Foreign investors that are allocated capital gain dividends in a given year from a fund are subject to federal income tax and federal income tax filing obligations for those capital gain dividends. The treatment of capital gain dividends is particularly important for funds that invest through REITs. Distributions that otherwise would have been capital gain dividends are not subject to FIRPTA if they are made on a class of stock that is regularly traded on a U.S. established securities market when received by a person that did not own more than 5 percent of that class of stock during the one-year period before the distribution, meaning those amounts are less material to shareholders of public REITs.[27]

The taxation of capital gain dividends differs dramatically among different foreign investors, and that will in turn affect how they choose to invest in funds that use REITs. Because QFPFs are exempt from FIRPTA, and because capital gain dividends are treated as gain from the sale of a U.S. real property interest rather than FDAP, QFPFs are generally exempt from any federal income tax on capital gain dividends.[28] Foreign individuals, or entities such as specified trusts that are treated as individuals, will be subject to tax on capital gain dividends but will generally receive the benefit of individual capital gain rates. This means they will pay federal income tax at a 20 percent rate on capital gain dividends. Foreign corporations are taxed on capital gain dividends at the corporate rate but are also subject to the branch profits tax, resulting in an aggregate 44.7 percent federal income tax burden if not reduced by a treaty.

The IRS is of the view that section 892 does not exempt foreign governmental entities from taxation on capital gain dividends, even if received as part of a liquidating distribution. Therefore, these investors also pay tax at a rate of up to 44.7 percent unless another exemption (such as the one applicable to QFPFs) applies or an applicable treaty reduces the rate of branch profits tax.[29] However, a capital gain dividend does not endanger a foreign governmental entity's overall exemption under section 892 in the same manner that commercial activity income could.[30]

C. Gain From Sale of REIT Shares

Gain from the sale of shares of a corporation generally is sourced to the jurisdiction of the residence of the seller. This means that if it is received by a foreign investor, that gain is not U.S. source and not subject to federal income tax.[31] However, gain from the sale of a U.S. real

[23] Section 871(h); reg. section 1.871-14(h).

[24] Section 163(j)(7)(A)(ii).

[25] Section 163(e)(5).

[26] Section 897(h)(1).

[27] *Id.*

[28] Section 897(c)(3).

[29] Notice 2007-55, 2007-2 C.B. 13.

[30] Prop. reg. section 1.892-4(e)(iv).

[31] Section 865(a).

property interest — including shares in a U.S. corporation if the value of its U.S. real property interests is 50 percent or more of the value of all of its real property interests and trade or business property (a U.S. real property holding corporation) — is treated as effectively connected with a U.S. trade or business and therefore subject to federal income tax.[32] Fortunately, a REIT that is less than 50 percent owned by foreign persons during the relevant testing period (usually five years) is treated as a domestically controlled REIT, and interests in a domestically controlled REIT are not treated as U.S. real property interests.[33]

Given the limitations surrounding the types of assets that can be owned by a REIT, generally a REIT that owns equity in U.S. real estate will be treated as a U.S. real property holding corporation unless domestically controlled. If domestically controlled, the REIT would not be a U.S. real property holding corporation, and foreign investors would be able to sell shares of the REIT (or be allocated gain from a fund's sale of shares of the REIT) without any federal income tax, even if the same investor would have been taxable on capital gain dividends from that REIT. Many foreign investors will require a fund to (1) form REITs that are domestically controlled and (2) exit through the sale of REIT shares rather than have the REIT sell property and make a capital gain dividend. This is because the former is exempt from federal income tax for a foreign investor while the latter gives rise to federal income tax payment and filings.

Some foreign investors are able to sell REIT shares, or receive an allocation of gain from the sale of REIT shares, without federal income tax even if the REIT is not domestically controlled and is treated as a U.S. real property holding corporation. Governmental investors that qualify for the benefit of section 892 are exempt on gain from sales of REIT shares as long as the REIT is not a controlled commercial entity for that investor, even if the REIT is not domestically controlled.[34] The IRS confirmed that treatment when expressing its view that capital gain dividends do not benefit from an exemption under section 892.[35] QFPFs are exempt on gain from sales of REIT shares (including if allocated to the QFPF from a fund) under section 897(1) regardless of whether the REIT is domestically controlled.

The determination of whether a REIT is domestically controlled has been complicated by the QFPF exemption, which calls into question whether QFPFs count as foreign ownership for those purposes. Before the addition of section 897(1), it was clear that a QFPF, like all foreign persons, was treated as a foreign person in determining whether a REIT is domestically controlled. However, section 897(1) provides that for purposes of section 897, "a qualified foreign pension fund shall not be treated as a nonresident alien individual or a foreign corporation."[36] The definition of domestically controlled is also found in section 897, and looks to ownership by foreign persons.

If a QFPF is not an NRA individual or a foreign corporation for purposes of section 897, it follows that it would not be a foreign person for purposes of the domestically controlled test and, as a result, would count as "good" non-foreign ownership for purposes of that test. Although a QFPF would usually be indifferent to whether a REIT is domestically controlled because it is exempt on a sale of REIT shares regardless of whether the REIT is domestically controlled, other foreign investors may benefit. Although the words of the statute seem clear, it also seems unlikely that Congress intended to change the domestically controlled test when exempting QFPFs from FIRPTA.[37] Taxpayers should take care before assuming that QFPF ownership is good in determining domestic control.

[32] Section 897(a).

[33] Section 897(h)(2) and (4)(B).

[34] Reg. section 1.892-3T(a)(1).

[35] Notice 2007-55.

[36] Section 897(1)(1).

[37] The legislative history of section 897(1) suggests that its purpose was that "in determining the U.S. income tax of a qualified foreign pension fund, Code section 897 does not apply." Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the House Amendment to the Senate Amendment to J.R. 1625 (Rules Committee Print 115-66)," JCX-6-18 (Mar. 22, 2018). Nothing suggests that Congress was trying to change the taxation of non-QFPFs that invest in REITs alongside QFPFs.

D. Use of REITs to Originate Mortgage Debt

While the prior discussion focused on REITs making equity investments in U.S. real property, REITs can also originate debt secured by real property, which raises issues similar to that of equity investing in real property. Trading in stock and securities for one's own account does not constitute a U.S. trade or business.[38] Funds often take the view that infrequent loan investments, particularly in debt acquired on the secondary market or in unsecured debt, fit within this safe harbor. However, at some point the amount and scale of a fund's debt origination activities will cause the fund to be engaged in a banking, financing, or similar business.[39] Such a business would cause foreign investors in the fund to be required to file federal income tax returns and pay federal income taxes, in a similar manner to that described earlier. If a fund is originating debt secured by real estate, it should consider doing so through a REIT.[40]

As a threshold matter, debt secured by real property produces good REIT income and constitutes good REIT assets. At least 75 percent of a REIT's income must consist of specified real-estate-related income, which includes interest on obligations secured by mortgages on real property or secured by interests in real property.[41] Amounts received as consideration for entering into agreements to make those loans, such as commitment fees, also qualify as good income for these purposes unless the amounts are determined based on income or profits.[42] For purposes of the REIT asset test, a real estate asset includes interests in mortgages on real property or on interests in real property.[43] Thus, a REIT can engage in a banking, financing, or similar business, as long as the relevant loans are secured by real property or by interests in real property.

As described earlier, a REIT converts income that would have been treated as effectively connected with a U.S. trade or business if recognized directly by the fund into U.S.-source FDAP. Unlike equity, a debt instrument secured by real property does not constitute a U.S. real property interest for purposes of the FIRPTA rules unless the lender shares in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property.[44] Therefore, plain vanilla debt without participation features and with a rate that is fixed or that floats based on some reference rate, such as LIBOR, does not constitute a U.S. real property interest, and sales of that debt will not trigger a capital gain dividend. However, a fund will need to take care with transactions involving loans that have participation features and with sales of equity interests in real property on which it has previously foreclosed, because either of those could trigger gain from the sale of a U.S. real property interest.

Although a REIT may prevent a non-U.S. investor in a fund from recognizing income effectively connected from a U.S. trade or business as a result of the origination, it may also impose withholding tax leakage. The distributions made by a REIT that owns debt are generally going to be treated as ordinary dividends and subject to withholding as described earlier. Foreign investors will need to look to a treaty provision or the benefits of section 892 to reduce or eliminate that withholding. In this way, the treatment of foreign investors in REITs that invest in debt is less favorable than the treatment of similarly situated foreign investors in RICs. A RIC is able to pass through portfolio interest to its foreign investors, so that the RIC does not need to withhold on distributions that are attributable to interest that would have qualified for the portfolio interest exemption if received directly by a foreign investor.[45] Unfortunately, REITs do not benefit from a similar rule.

[38] Section 864(b)(2)(A).

[39] Reg. section 1.864-5.

[40] There are several other strategies that a fund can use to avoid non-U.S. investors being treated as engaged in a U.S. trade or business as a result of debt origination activities, including acquiring "seasoned" debt from a third party or affiliate, investing through a treaty jurisdiction, or using a business development company (taxed as a RIC under section 851).

[41] Section 856(c)(3)(B).

[42] Section 856(c)(3)(G).

[43] Section 856(c)(5)(B).

[44] Reg. section 1.897-1(d)(2).

[45] Section 871(k).

E. Foreign Investors — A Summary

Funds seeking to raise investment capital from foreign investors should consider the use of REITs to minimize or eliminate the U.S. income tax burden faced by those investors. Some foreign investors are now in the enviable position of being able to invest in U.S. real estate through REITs and pay no federal income tax. QFPFs that qualify for the benefits of section 892 or some U.S. income tax treaties, like those with Canada or the Netherlands, may be completely exempt from withholding on ordinary dividends from noncontrolled REITs, and also exempt on capital gain dividends and gain from sale of shares of REITs under section 897(1). A foreign governmental investor that is not a QFPF will also be exempt on ordinary dividends from a noncontrolled REIT and on the sale of REIT shares, but not on capital gain dividends. Given that those investors would be taxed if a REIT sells property and distributes the proceeds as a capital gain dividend but would not be taxed on a sale of REIT shares, they should be expected to negotiate protections around exits to ensure that the fund sells REIT shares rather than property.

V. Tax-Exempt Investors

Most U.S. tax-exempt entities are subject to federal income tax on their unrelated business taxable income.[46] UBTI arises in one of two ways. First, income generated from a trade or business that is otherwise unrelated to a tax-exempt investor's exempt purposes may be treated as UBTI. Second, to the extent that a U.S. tax-exempt entity owns property on which it has incurred acquisition indebtedness, a portion of the income arising from that property is treated as UBTI.[47]

Funds often seek investments from U.S. tax-exempt entities that are subject to UBTI, such as corporate pension plans, charitable foundations, and private university endowments. Although there are exceptions that could allow funds to invest in real estate without generating UBTI and without using REITs, those exceptions are difficult to manage in practice and may cause funds to instead invest through REITs to accommodate the needs of U.S. tax-exempt entities.

Although income arising from an unrelated trade or business (including through partnerships) generally is treated as UBTI, there is an exception for rents from real property and gain from the sale or exchange of property other than property that is treated as the taxpayer's inventory or primarily held for sale to customers in the ordinary course of a trade or business.[48] This would appear to cover the principal cash flows arising from an investment in real property, rent, and gain from sale. However, payments do not qualify for this exception if they are made for premises where non-customary services are also rendered to the tenant. Examples of problematic services include supplying maid service and providing specified parking.[49] Funds that provide these services generally will be required to report some UBTI to their partners. This is especially problematic in high-end residential properties and hybrid residential-commercial development because new residential development often competes on the basis of better amenities, some of which may be non-customary and therefore give rise to UBTI. A fund that pursues these investments may find that a portion of its income that appeared to be rents is actually UBTI.

For debt-financed UBTI, section 514(c)(9) treats some debt incurred by a qualified organization to acquire real property as non-acquisition indebtedness and therefore as not generating UBTI. For a partnership to use this exception, it must meet the allocation rules colloquially referred to as the "fractions rule."[50] Although a detailed description of the fractions rule is beyond the scope of this report, several of the requirements may be difficult for a fund to meet.[51]

A fractions-rule-compliant fund must liquidate in accordance with capital account

[46] Section 511.

[47] Section 514(a)(1).

[48] Section 512(b)(3) and (5).

[49] Generally, good income for REIT purposes is coterminous with income that qualifies for the exception from UBTI. However, the IRS has suggested that REITs have more flexibility for parking arrangements. Rev. Rul. 2004-24, 2004-1 C.B. 550.

[50] Section 514(c)(9)(E).

[51] Separate from the fractions rule, section 514(c)(9) imposes other limitations on contingent purchase price and some sale-leasebacks that may be problematic.

balances. This is unusual for a fund and may raise concerns that a liquidation in accordance with capital account balances results in a different cash distribution than would arise if the fund liquidated in accordance with its distribution waterfall. Moreover, the fractions rule disallows some disproportionate allocations to partners, which makes standard fund economic terms (such as differing management fees for different partners and a general partner clawback in the event of an overpayment of carried interest) difficult to implement. Finally, although the fractions rule will prevent universities and pension plans from recognizing UBTI as a result of acquisition indebtedness, it does not apply to other tax-exempt entities, such as most charitable organizations or endowments that are exempt under section 501(c)(3).

In contrast, if a fund invests in real property through a REIT, the REIT will generate dividend income and gain from a sale, both of which are exempt from taxation as UBTI unless the REIT is pension held or if the fund or tax-exempt investor has acquisition indebtedness for its REIT shares.[52] A REIT will be pension-held if (1) it is required to look through one or more U.S. pension investors to avoid being closely held (as discussed later) and (2) either (A) one pension investor owns more than 25 percent of the REIT's interests or (B) one or more pension investors each owning more than 10 percent of the REIT's interests in the aggregate own more than 50 percent of the REIT's interests.[53] If a REIT is pension held, a UBTI-sensitive pension fund owning 10 percent or more of the REIT will have to treat a portion of the REIT dividends received by it as UBTI in a ratio equal to the ratio of the REIT's income that would have been UBTI if the REIT itself were a pension investor. Funds should monitor the ownership by pension investors to avoid any REIT becoming pension held. Funds should also avoid having acquisition indebtedness for REIT shares by causing the REIT itself to borrow permanent debt, rather than causing the fund to borrow and contribute the proceeds to the REIT. In that way, funds can invest in real estate through REITs and avoid generating UBTI to their investors.

VI. Issues Faced by REITs Owned by Funds

Having explored why funds use REITs in making their real estate investments, this report turns to some unique issues faced by funds in doing so. These issues tend to arise either regarding the many organizational tests applicable to REITs or as a result of the concentration of REITs owned by funds when compared with public REITs. This report investigates related-party rent issues, issues faced by private REITs in availing themselves of the dividends received deduction, and issues surrounding the management of private REITs. This list is far from exhaustive, and there are other issues faced by private REITs (such as the need to have 100 shareholders) that are not addressed here.[54]

A. Related-Party Rents

REITs owned by funds face particular difficulty with the fact that rents received by a REIT are excluded from the definition of rents from real property if the REIT owns (directly or indirectly) at least 10 percent of the total combined voting power or value of the shares (or at least 10 percent of the assets or profits for a noncorporate lessee) of the person directly or indirectly paying the rents (the related-party rent rule).[55] The related-party rent rule is an important way to limit taxpayers' ability to improperly use REITs to reduce their corporate tax liabilities.[56] For instance, in the absence of the related-party rent rule, a REIT could lease properties to an affiliated corporation with rents that exceed those charged in third-party arrangements, and then strip income from the taxable corporation into the

[52] Section 512(b)(1) and (5).

[53] Section 856(h)(3)(D).

[54] In short, REITs owned by funds typically issue a preferred share with a fixed coupon for $1,000 (or less) to more than 100 separate shareholders. Such shares used to be issued to "friends and family" of the fund. Now there are several services that will place preferred shares with suitable investors.

[55] Section 856(d)(2)(B).

[56] H.R. Rep. No. 86-2020, at 7 (1960). The legislative history of section 856 suggests that the related-party rent rule was enacted to prevent the avoidance of taxation "with respect to rents from real property through the device of setting up a related organization. It also forecloses the opportunity of any substantial relationship between the trust and the business of the tenant."

REIT, where the income would not be subject to corporate tax. However, in the context of REITs owned by funds, the related-party rent rule can be overly broad and apply to situations in which not only is there no tax abuse but neither the REIT nor its owners are even aware that they are violating the rule.

The attribution rules of section 318 apply in determining whether a REIT owns an interest in a tenant for purposes of the related-party rent rule, with two important exceptions.[57] First, stock is attributed to and from a corporation and its stockholder if the stockholder owns, directly or indirectly (including through attribution), 10 percent or more of the value of the stock of that corporation, as opposed to the usual 50 percent threshold. Second, stock owned by a partner is attributed to a partnership only if the partner owns 25 percent or more of the capital interest or the profit interest in the partnership.

The related-party rent rule applies in a pretty straightforward way to public REITs, which have a reasonably diverse ownership by direct shareholders. Assuming that a REIT doesn't itself have an ownership interest in a tenant, the REIT must ensure that ownership of one of the REIT's tenants not be attributed to the REIT from one or more of its stockholders under the constructive ownership rules. This would happen if one of the stockholders owned 10 percent or more of the shares in the REIT. For a public REIT, this is fairly unlikely. That is because ownership is generally spread among a reasonably large number of shareholders, shareholders owning more than 5 percent are generally subject to special reporting under the securities laws,[58] and many public REITs have provisions in their governing documents limiting the ability of holders to own 10 percent or more of their shares. These all serve to allow a public REIT to get comfortable that an ownership interest held by one or more of its stockholders in a tenant to which the REIT rents real property will not be attributed to the REIT and cause the rents to cease to qualify as rents from real property.

The same analysis for a REIT owned by a private investment fund is considerably more complex because there are two ways that the REIT could be attributed shares owned by the REIT's indirect owners. First, any partner that owns 25 percent or more of the fund would find stock owned by it attributed to the fund, and thus attributed to the REIT because the fund owns all the REIT's common stock. This appears to be the attribution envisioned by the related-party rent rule, which turns off attribution to partnerships if a partner owns less than 25 percent of the partnership.

However, the attribution can also be tested by first attributing the REIT shares to the fund partners pro rata based on their ownership of the fund.[59] Assuming that the fund owns 100 percent of the common stock of the REIT, any partner that owns 10 percent or more of the fund would be attributed 10 percent or more of the REIT. Because shares constructively owned under section 318 are generally treated as actually owned for purposes of reattribution,[60] each such partner is treated as owning more than 10 percent of the REIT. Therefore, the partner's ownership of the REIT is sufficient to allow stock owned by that partner to be attributed directly to the REIT. While at first glance it would appear that the fund does not need to concern itself with partners unless they own 25 percent or more of the fund, in actuality the fund has to track whether any partner owning 10 percent or more of the fund owns interests in a tenant.

The related-party rent rule can be even more difficult for a fund because it doesn't differentiate between arrangements negotiated on an arm's-length basis versus off-market leases, nor is it relevant whether the parties negotiating the lease were aware of the relationship. If a tenant becomes related to a REIT, the related-party rent rule will apply even if the tenant and REIT were unrelated when the problematic lease was negotiated. A REIT owned by a fund could rent property to a tenant, and years later, while the

[57] Section 856(d)(5).

[58] 17 C.F.R. section 240.13d-1 (a beneficial owner, defined as any person who directly or indirectly acquires more than 5 percent of the outstanding shares of a class of stock, must file a beneficial ownership report in a Schedule 13D or 13G until that owner's holdings fall below 5 percent).

[59] Section 318(a)(2)(A).

[60] Section 318(a)(5)(A).

lease is still in effect, an investor that owns 10 percent of the fund might acquire a 10 percent interest in the tenant. The fund may have no knowledge of the acquisition, which might have occurred in a subsidiary of the investor or even in an unrelated investment fund in which the investor has an interest. Once that acquisition happens, rents received by the REIT from that tenant (including for the entire tax year in which the REIT and tenant become related) no longer qualify as rents from real property, and the REIT's qualification as a REIT may be in danger.

What can sponsors of funds that invest in REITs do to protect against this risk? Unfortunately, there's no perfect solution under current law. It's difficult for investors in a fund to agree that they will never own an interest in a tenant, particularly when the REIT may be leasing to new tenants all the time and the investor may be unable to control whether it is attributed interests in a tenant from other funds. However, a fund should establish a system in which it monitors ownership of tenants by 10 percent or greater investors, including by doing a regular questionnaire designed to understand whether the fund's investors have acquired interests in existing tenants or own interests in new tenants. A fund should also consider negotiating the ability to force an investor whose interest in the fund creates REIT compliance problems under the related-party rent rule to have its ownership of the fund reduced through sale or redemption below 10 percent to avoid attributions issues.

The IRS and Treasury could mitigate some of the inequity of the related-party rent rule as applied to private REITs. For instance, a REIT can remedy a failure of the income test if it is able to show reasonable cause for that failure.[61] The IRS should liberally grant this remedy for unknowing violations of the related-party rent rule. Moreover, Treasury should consider promulgating a regulation providing that if a person is treated as owning shares in a REIT through attribution from a partnership, stock owned by that person is attributed to the REIT only if the person indirectly owns at least 25 percent of the REIT. This would end the odd result in which a 10 percent investor in a fund has its ownership of stock attributed to the REIT. It would also more closely match congressional intent in requiring that an investor own 25 percent of a partnership before stock owned by the investor is attributed to the partnership for purposes of the related-party rent rule.

Finally, Congress could revise the related-party rent rule to focus more directly on abusive situations. For instance, leases negotiated without knowledge of the relationship between a REIT and its tenant would generally not pose the same risk of shifting income to the REIT as leases negotiated between parties that were aware of the arrangement. Maybe the former leases should be exempt from the related-party rent rule. Similarly, a lease negotiated before the REIT and tenant were related would also be much less problematic and perhaps should be exempt from the related-party rent rule.

B. Dividends Paid Deduction

A REIT's ability to deduct dividends that it pays is crucial to its ability to eliminate its taxable income every year. A REIT that makes distributions annually in an amount equal to its annual income and in a manner qualifying for the dividends paid deduction will be able to reduce its taxable income to zero and eliminate its federal income tax (other than various excise taxes). As discussed later, an IRS ruling on preferential dividends raises issues for private REITs in light of management fees charged at the fund level. Moreover, a REIT owned by a fund may find that it is unable to deduct some liquidating distributions if the REIT is treated as a personal holding company (PHC).

1. Differing management fees and preferential dividends.

A fund almost always pays its manager a quarterly or semiannual management fee as compensation for management of the fund and its investments. How this management fee is calculated differs among funds. Sometimes it is calculated as a percentage of the amount invested in the fund or a percentage of the value of the fund's investments. Sometimes it is calculated as a percentage of the capital commitments made by investors to the funds. And sometimes it is

[61] Reg. section 1.856-7 (explaining that a REIT must pay a penalty tax measured by the amount of the "bad" REIT income); section 857(b)(5).

calculated as a percentage of the fund's net asset value. Although it is charged at the fund level, the management fee is usually funded through capital contributions by the fund's investors or paid with cash that otherwise would be distributed to the fund's investors. Thus, it is effectively borne by the fund's investors.

Fund managers often negotiate different fee arrangements with different investors. For instance, the fund manager may be paid a lower percentage fee for large investors than for small investors. Similarly, the fee may be reduced for investors that have participated in several of the fund manager's other products, or that commit to the fund earlier than other investors. The fund's governing documents usually provide that if the fund's manager negotiates reduced fees for one or more investors, that fee reduction is credited to those investors. They either contribute less to the fund in light of their reduced fee burden, or less of the cash flow that would otherwise get distributed to them is paid over to the manager as a fee. In other words, any fee reductions are not shared with the other investors. Similarly, the fund's general partner and some of its affiliates may not pay any management fee. The remainder of this discussion considers whether this arrangement creates an issue in allowing a REIT held by the fund to avail itself of the dividends paid deduction.

For a private REIT, the dividends paid deduction is available only for distributions that are pro rata, without preference to any share of stock compared with any other shares in the same class, and without preference between classes of stock except to the extent that one class is entitled (without any waiver of shareholder rights) to that preference.[62] This requirement has been interpreted broadly as it relates to management fees. The IRS has ruled that a private REIT with two classes of shares that charge different management fees to different investors (generally based on the amount invested) — such that each class pays different dividends to account for the differing fees — violates the preferential dividend rule, except when the differences result from administrative savings attributable to differing investment sizes by different investors.[63] Any such REIT would not benefit from the dividends paid deduction for those dividends.

LTR 201444022 is unusual in several respects. It is rare for a private letter ruling to reach a result that's unfavorable to the taxpayer. Moreover, the structure described by the letter ruling does not seem to violate the preferential dividend rule on its face. That rule does not prohibit a REIT from paying different dividends to different classes of stock; instead, it provides that different dividends on different classes of stock are problematic only if the different classes are not entitled to the preference. In the letter ruling, the different classes of shares were entitled by their terms to participate in different dividend levels. The IRS asserted that because the only difference between the classes of stock was the amount of management fee they each bore, the classes should be treated as a single class for purposes of the preferential dividend test. As a result, the fact that different shares in what is now viewed as the same class receive different dividend amounts creates a preferential dividend issue.

LTR 201444022 presents the question of whether a fund that invests through REITs and has different management fees for different investors creates a preferential dividend issue for the REITs. The answer to that question should be no. In form, a REIT owned by a fund will have only one class of common equity, 100 percent of which is owned by the fund. In the absence of different shareholders that receive different amounts from the REIT, in order to create a preferential dividend, the fund itself would have to be ignored. If the fund were ignored, the IRS could assert that the management fee is then paid by the REIT, and different investors in the fund directly receive different dividend distributions on the single class of common stock to account for their differing management fees.

The IRS should not be able to disregard the presence of the fund in most cases. The agency can disregard a partnership when it is formed or used in connection with a transaction a principal purposes of which is to substantially reduce the present value of the partners' aggregate federal

[62] Section 562(c). Publicly offered REITs are exempt from this rule.

[63] LTR 201444022.

tax liability in a manner that's inconsistent with the intent of the partnership rules.[64] That is clearly not the case with a fund making investments through a REIT and charging differing management fees at the fund level.

The differing management fees are not being charged for any tax purposes but instead are negotiated business arrangements reflecting the different leverage and business deals with different investors. The interposition of the fund/partnership between the investors and the REIT is also not necessarily tax motivated. The use of those vehicles is almost uniform in the private equity industry, regardless of whether REITs are used. For instance, a REIT is not easily able to pay a carried interest, which is almost uniformly received in private equity funds. Moreover, the fund serves a variety of nontax goals, including providing all partners with the benefits of the relevant partnership law, permitting non-REIT investments, and governing when and how capital is called and investments are made.

Finally, a rule in which differing management fees at a partnership affected the ability of a REIT owned by the partnership to pay deductible dividends would be almost completely unworkable. For instance, if multiple partnerships own interest in a single REIT, would the fact that one of those partnerships has differing management fees cause all REIT dividends to be nondeductible? Would a partnership need to look up to its investors as well, to ensure that none of them were funds of funds or other partnerships with differing management fees? Given the key nontax reasons for use of a fund and the difficulty of ignoring the fund from an administrative perspective, the separate identity of the fund should be respected, and the payment of different management fees at the fund level should not affect the ability of a subsidiary REIT to claim the dividends paid deduction.

2. Liquidating distributions and the dividends paid deduction.

Generally, a distribution in liquidation qualifies for the dividends received deduction. However, if the distributing corporation is a PHC, the distribution qualifies for the dividends paid deduction only to the extent that the amount is distributed to a corporation, among other requirements.[65] When a REIT makes a liquidating distribution, the REIT must ensure that it is not a PHC.

A company is a PHC in any given tax year if at least 60 percent of its adjusted ordinary gross income consists of PHC income, and during the last half of the year more than 50 percent of the value of its stock is directly or indirectly held by five or fewer individuals (or entities treated as individuals).[66] Discerning readers may ask how a REIT could ever be a PHC since a REIT must not be closely held for purposes of the stock ownership requirement of the PHC rules.[67] If an entity meets the closely held test of the PHC rules, how could it qualify as a REIT?

The determination of whether an entity is closely held for REIT qualification purposes differs in important ways from the determination of whether an entity is closely held for purposes of the PHC rules. These differences allow a REIT to possibly still be a PHC.

In determining whether an entity is closely held for purposes of the PHC rules, an individual is treated as owning stock owned directly or indirectly by that individual's partners.[68] This attribution rule does not apply in determining whether an entity qualifies as a REIT.[69] If a fund owns all the common stock of a REIT and the fund has even one individual partner, no matter how small, all the shares owned by the fund are attributed to its partners, and all those shares are attributed to the individual partner. Thus, 100 percent of the REIT's common stock is deemed owned by an individual for purposes of the PHC rules, and the REIT will be treated as closely held for purposes of those rules.[70] For REIT qualification purposes, the individual is (sensibly) attributed only his indirect proportionate interest

[64] Reg. section 1.701-2(b).

[65] Section 562(b)(2).

[66] Section 542(a).

[67] Section 856(h)(1).

[68] Section 544(a)(2).

[69] Section 856(h)(1)(B).

[70] *But see* LTR 201208025 (ruling that partner-to-partner attribution does not create a PHC).

in the REIT shares rather than being attributed everything owned by the fund.

A second distinction between the REIT rules and the PHC rules is that for purposes of the PHC rules, ownership by a pension plan described in section 401(a) is treated as ownership by an individual and can cause an entity to be treated as closely held. For purposes of REIT qualification, a REIT is able to look through a pension plan described in section 401(a).[71] Although pension plan ownership may cause a REIT to be pension held, as discussed earlier, it will not cause a REIT to be closely held and lose its REIT status. Importantly, though, and unlike the result under the partnership attribution rule described earlier, if a REIT avoids closely held treatment as a result of looking through pension fund investors, it will not be treated as a PHC.[72]

Given a REIT's need to deduct liquidating distributions, how can a fund ensure that a REIT in which it invests will not be treated as a PHC by virtue of small individual partners in the REIT? First, the PHC test has two prongs: the closely held test and an income test. A fund can monitor REIT subsidiaries to ensure that less than 60 percent of their income is PHC income. Although rent is generally considered PHC income, there's an exception if, among other requirements, more than 50 percent of an entity's income consists of rent. Many REITs will meet this test, although REITs formed to invest in debt secured by real property, or REITs that have sold their income-producing property but not yet liquidated, may fail it.[73]

The fund also can move individuals into a feeder fund that is treated as a partnership for federal income tax purposes and invests in the fund. Generally, the individual ownership in a fund is relatively small, and absent the partner-to-partner attribution rule would be insufficient to give rise to a closely held issue. By putting individuals into a feeder, each individual investor's direct partners are now the other individuals that share the feeder. As long as the feeder indirectly owns less than 50 percent of the REIT, the individuals would not cause the REIT to be closely held for purposes of the PHC rules. Most funds would meet this test if they structured individual investments through a feeder fund. If they didn't, their ownership would likely be sufficiently concentrated to present REIT issues anyway.

C. Private REIT Management

To qualify as a REIT, an entity must be "managed by one or more trustees or directors."[74] This requirement is of particular concern to REITs that are not formed as corporations or trusts from a legal perspective. A fund investing through a REIT may have several reasons to prefer to form the REIT as an entity other than a corporation or trust. For instance, foreign investors may prefer that the REIT be treated as tax transparent for purposes of the investors' local tax laws, in which case they might have the REIT formed as a limited partnership, which is usually flow-through for foreign tax purposes. There may be state tax benefits in the jurisdictions where the REIT invests that encourage using a different type of entity. Finally, from a governance perspective, it may be simpler to use a limited liability company or other entity as the REIT.

Filing a REIT election also serves as a check-the-box election to treat the REIT as a corporation, effective for the first day it is treated as a REIT.[75] Thus, a REIT is always a corporation from a federal income tax perspective. The requirement that a REIT be managed by one or more trustees or directors is a vestige of *Morrissey*, other precedents, and the rules that preceded the check-the-box regulations. However, just because a REIT is a corporation for these purposes does not necessarily mean that it is managed by one or more trustees or directors. Determining whether the management requirement is met necessitates an analysis of the governance of the REIT, and it is not determined by whether the REIT is treated as a corporation for federal income tax purposes.

[71] Section 856(h)(3)(A).

[72] Section 856(h)(3)(B).

[73] A REIT that has sold its properties and is awaiting liquidation should also take care to continue to meet the REIT asset and income test. Often, those REITs will acquire a small number of public REIT shares or other liquid assets that satisfy these tests but give rise to passive income for purposes of the PHC income test.

[74] Section 856(a)(1).

[75] Reg. section 301.7701-3(c)(1)(v)(B).

The term "directors" is not defined in the applicable code provisions or regulations. However, any term without an applicable definition in the REIT tax provisions is defined by reference to the Investment Company Act of 1940.[76] Fortunately, the 1940 act provides for a broad definition of what it means to be managed by one or more trustees or directors.

Section 2(a)(12) of the 1940 act defines a director as "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member of a board of trustees of a management company created as a common-law trust." The SEC and the courts have taken the position that a general partner of a limited partnership or a trustee of a trust generally performs functions similar to those of a director of a corporation and therefore would be a director for purposes of the 1940 act.[77] The SEC staff has also taken the position that a right to vote on the election or removal of a general partner is similar to the right to vote on the election of directors of a company.[78] Although there's no direct precedent on point, generally a similar analysis should apply to treat the managing member of an LLC as a director for these purposes. Thus, the requirement that a REIT be managed by one or more directors or trustees should not serve as a material impediment to using entities that are not corporations or trusts under local law as REITs.

VII. Conclusion

In summary, although REITs were designed to aggregate a large number of investors into a public or quasi-public vehicle, they also offer important benefits to funds. REITs are a particularly tax-effective vehicle for a fund's foreign and tax-exempt partners to invest in U.S. real estate, especially for QFPFs after they were made exempt from FIRPTA under section 897(1).

Although funds have changed the way that they invest in U.S. real estate to use REITs more frequently, the REIT rules have not evolved to fit the modern use of REITs by funds. Many of the REIT organizational requirements that contemplate a diverse shareholder base derive from law that predates the modern check-the-box rules, and they don't serve a meaningful tax policy goal. A fund's partnership status or fee structure can endanger a REIT's ability to deduct its dividends paid. Again, these issues serve more as traps for the unwary rather than furthering any tax policy. Finally, although the related-party rent rules serve an important policy goal, when applied to funds, they have the potential to cause non-abusive leases to generate bad REIT income and endanger a REIT's tax status. ■

[76] Section 865(c)(5)(F).

[77] *See* SEC, "Investment Company General Partners Not Deemed Interested Persons," IC-18868, at n.5 (July 28, 1992) (stating that the "directors of limited partnerships are general partners"); and *Chabot v. Empire Partnership Co.*, 301 F.2d 458 (2d Cir. 1962) (noting that the functions of a trustee are similar to those of a director). *See also* Murphy Favre Properties Inc., SEC staff no-action letter (May 26, 1987); and Integrated Resources Inc., SEC staff no-action letter (June 1, 1979).

[78] *E.g.*, Standish Equity Investments Inc., SEC staff no-action letter (Dec. 15, 1993).