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What Is a REIT To Do? De-REITing and Private REIT Combination Strategies

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BACKGROUND:

Public real estate investment trusts ("REITs") and private equity funds often use subsidiary REITs (sometimes referred to as "baby" or "private" REITs) to structure real estate investments with a specific type of co-investor in mind. For example, a private equity fund may consider investing in a real estate portfolio and raise capital from a group of co-investors that are a mix of U.S. indiduals, U.S. non-profits (e.g., university endowments and public pension funds), non-U.S. high-net-worth individuals, pension funds or sovereign wealth funds of foreign governments. Generally, tax-exempt or foreign investors prefer not to invest directly in U.S. real estate or through a partnership or limited liability company that is treated as a pass-through entity for U.S. tax purposes.

Tax-exempt and foreign investors.

A tax-exempt investor generally is not subject to U.S. federal income tax. However, tax-exempt investors are subject to tax on their unrelated business taxable income ("UBTI").1 While rents from real property and gain on the sale of real property are typically not unrelated business taxable income, rents and gains from debt-financed property are typically not unrelated business taxable income, rents and gains from debt-financed property would be subject to tax.[2] Given that debt is often, if not always, used to acquire or develop real estate, rents from and gains on the sale of U.S. real property result in unrelated business taxable income and subject a tax-exempt investor to U.S. tax.[3]

Foreign investors generally are subject to U.S. taxation on rents from and gains on the sale of U.S. real property (whether owned directly, through a pass-through entity such as a limited liability company or limited partnership, or through a U.S. corporation with assets that are predominantly U.S. real estate).[4] Typically, foreign investors seek to avoid being subject to U.S. taxation on their real estate investments but also, and some times more importantly, seek to avoid filing U.S. income tax returns altogether.[5]

The use of private REITs is a common investment vehicle for tax-exempt and foreign persons to invest in U.S. real estate in a tax-efficient way. For example, a tax-exempt investor may receive dividends from a private REIT that are exempt from U.S. tax. Moreover, a sale of REIT shares would not subject the tax-exempt investor to U.S. income tax.[6] Similarly, a foreign investor in a domestically controlled REIT ("DCR") can sell the REIT shares free of U.S. tax.[7] In addition, qualified foreign pension funds ("QFPFs") are exempt from U.S. income tax on the sale of shares of a REIT or capital gain dividends (those dividends derived from the sale of a U.S. REITs real estate), whether or not the REIT is a DCR.[8]

Depending upon the tax profile of investors in a private REIT, the structure can take on various forms. Often, foreign investors will require single-asset REITs. In this case, a portfolio of assets may necessitate several separate REITs.

A simple example illustrates the structuring strategy. A private equity fund and foreign investor intend to acquire a portfolio of ten U.S. real estate assets. Each separate asset is placed in a separate REIT, whereby the private equity fund owns 51% of the shares and the foreign investor owns 49% of the shares.[9] As such, each separate REIT is a DCR. At exit, the transaction will be consummated as a sale of the REIT shares. In that case, the foreign investor will not be subject to U.S. income tax. If the ten assets were instead held in one REIT, the sale of one property may result in a capital gain dividend to the foreign investor which could be subject to U.S. income tax, depending on the foreign investor's jurisdiction and tax classification.

U.S. investors

Of course, U.S. investors also can enjoy the many tax benefits of REIT ownership. For example, REITs are not subject to corporate income taxes, provided they distribute their taxable income in the form of a dividend.10 While those ordinary dividends are subject to the highest U.S. income tax rate,11 investors that are individuals or trusts are able to deduct 20% of the dividends received for purposes of the qualified business income deduction under Section 199A. Further, dividends that are related to the sale of property are eligible for reduced capital gain rates.12 Lastly, a REIT eliminates the need for individual investors filing in the multiple states where the properties are located.

As a result, there are clear tax benefits to the use of a private REIT structure for both U.S. and foreign owners. However, maintaining REIT status can be both administratively costly and restrictive. While REITs were created to make real estate investing more accessible to the average investor, the tax rules were intended to ensure that REITs remain passive owners of real estate and do not participate in other businesses or activities.13 These rules, therefore, require REITs to meet various quarterly asset and annual income tests in order maintain REIT eligibility.

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REIT RULES: AN OVERVIEW

On a quarterly basis, 75% of a REIT's assets must be "real estate assets."[14] For this purpose, real estate assets include real property, interests in real property (such as a lease, an easement, or an option to acquire land) and interests in mortgages on real property, shares in other REITs, and debt instruments issued by publicly offered REITs.[15] On an annual basis, there are two income tests. The 75% income test mandates that income (for tax purposes) be derived from rents from real property, interest income on obligations secured by mortgages on real property, gains on sale of real property and dividends from other REITs.[16] For purposes of the 95% income test, all income from the 75% test is counted, in addition to dividends, interest and other portfolio income.[17]

In addition to the above requirements, a REIT's net income derived from prohibited transactions is subject to a 100% federal tax.[18] A "prohibited transaction" means a sale or other disposition of property held primarily for sale to customers in the ordinary course of business.[19] The legislative history underlying Code Section 857(b)(6) indicates the purpose of this section was to "prevent a REIT from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project."[20]

The above description of REIT rules is only a high-level overview. There are numerous nuances and ambiguities to the rules. In fact, when it comes to which services a REIT can provide to its tenants (remember, REITs are supposed to be investing "passively" in real estate), the Code and Treasury Regulations provide little guidance. The type of service provided, who is providing the service, how third parties are compensated, and whether the service is customarily provided in the geographical area where the property is located, are all issues that must be analyzed by REITs and their tax advisors. If an investment structure contains several private REITs, the above-mentioned asset and income testing required to ensure REIT status, along with the compliance cost of filing tax returns for each REIT, can be extremely expensive.

Additionally, given the uncertainty surrounding whether some activities generate good REIT [gross] income, REITs often must decide whether to forgo such income streams in order to remain REIT compliant. These decisions are often viewed through the lens of ultimately selling the REIT in the future. Buyers of REIT shares will scrutinize a REIT's activities and its asset and income testing from inception as much as, if not more than, its financial performance. Buyers will likely raise questions in the due diligence process regarding a REIT's tax compliance, and sometimes this can have a negative effect on the share price (and potentially jeopardize the sale).

REIT benefits vs. costs

While the costs to operate REITs are substantial, they generally are outweighed by the benefits to REIT ownership, especially for tax-exempt and foreign investors. But is that always the case?

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Real estate investments are subject to macroeconomic and microeconomic cycles like other asset classes. But in different real estate sectors, there are often quite different cycles, including shorter or longer recovery periods after certain identifying events. The office real estate market in particular saw an unprecedented decline in demand with the Covid-19 pandemic. The pandemic became a defining moment for the industry, one that may have forever changed the landscape and values that may have existed prior. For many office commercial real estate owners, full recovery to pre-pandemic periods is no longer possible; instead, they are looking to reposition their investments through debt restructuring, converting to mixed use, and adding amenities where it makes financial sense to salvage any remaining value. As discussed immediately below, depending on a REIT's financial performance, the compliance costs of qualifying as a REIT may outweigh the benefits.

As mentioned, REITs do not pay income tax on their taxable income, provided the REIT distributes its taxable income in the form of a dividend, referred to as the "dividend paid deduction."[21] A real estate company that is highly profitable will benefit from being a REIT and taking advantage of this dividends-paid deduction to avoid paying a corporate tax. On the other hand, REITs with lower profitability (and less cash flow) will not need to rely as much on the dividends-paid deduction to lower their tax exposure. For example, a hospitality or healthcare REIT may rethink its business strategy and choose to become an owner and operator of the facility. However, a REIT cannot do both. Therefore, lower profitability, together with the burdensome compliance costs, may make a case for a REIT to elect out of its special tax status (hereinafter referred to as "de-REITing").

In addition to the compliance burdens of having several REITs in an investment platform, depending on the asset classes amongst the REITs (office, logistics, residential, retail, etc.) some REITs may be performing well, while others are not. Certain REITs may be operating at a loss and not generating any taxable income or positive cash flow. Absent an anticipated turnaround for those REITs, there would be less of a need (or no need) to continue as a REIT and incur the burdensome compliance costs. On the other hand, other REITs with different asset types (or geographic locations) may be performing quite well, and their shareholders would continue to benefit from owning REIT shares.

The remainder of this article discusses certain structuring considerations for owners of multiple REITs that have varying financial track records and prospects.

DE-REITING

Practical implications of de-REITing.

A REIT that has low profitability or high leverage that requires significant cash to service debt (or both) may consider deREITing. Forgoing REIT status eliminates the need to distribute taxable income to shareholders (as well as eliminating the high cost of compliance, which also reduces available cash), allowing the former REIT to conserve cash, service its debt and avoid default. Other reasons to terminate REIT status could be if the company desires to acquire non-real estate businesses or expand non-REIT compliant revenue streams, such as asset management fees related to actively managing third-party assets.

Tax implications of de-REITing.

In order to initially elect REIT status, the entity making the election must otherwise be a taxable C corporation.[22] As a result, when a company elects to terminate its REIT status, it will revert to a taxable C corporation on a go-forward basis. There are no adverse tax consequences with the conversion of a REIT back to a C corporation.[23] Going forward, the former REIT will be subject to income tax on any taxable income and gains from the sale of real estate assets. All of the former REIT's tax attributes (e.g., adjusted tax basis in its assets, net operating losses, and various tax elections) should not change, provided the ownership of the former REIT does not change in the process of de-REITing. Therefore, any net operating loss carryovers from the tax periods when the corporation was a REIT should be available to offset (at least partially) any future income and gains from sales of real estate.

Note that while the former REIT will be subject to corporate-level tax on any income and gain it recognizes in the future, it will not be subject to the 100% prohibited transactions tax ("PHT") on the sale of its assets. The prohibited transaction tax in and of itself could be a consideration in de-REITing. For example, even if there are several properties sold at a loss, even one property sold at a gain could result in prohibited transaction tax. This is especially important where an entity has several sales in a particular year and thus might fall out of the prohibited transactions tax safe harbor, which we discuss in more detail below.[24]

On the other hand, a former REIT will continue to be a U.S. real property holding corporation ("USRPHC") under Section 897. This means that the sale of the shares of the former REIT will subject most foreign investors to U.S. tax on any gain recognized. The DCR exception would no longer exempt non-QFPF foreign investors from U.S. tax on the sale of the shares.

In addition, prior to the enactment of the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"), foreign investors were able to take advantage of the so-called "cleansing rule" whereby a USRPHC could sell all its assets in a taxable transaction and then liquidate.[25] At the time of liquidation, the U.S. entity would no longer be a USRPHC. As such, foreign investors would not be subject to U.S. tax on the liquidation of the entity. However, section 325 of the PATH Act changed the application of the cleansing rule such that, if a USRPHC had been a REIT in the prior five years, foreign investors would not be able to take advantage of the cleansing rule. This means that foreign investors would be subject to U.S. tax on any gain recognized as result of the liquidation of the former USRPHC.[26] Some tax commentators have pointed out that the prohibition against using the cleansing rule with regard to a taxable C corporation (even if the C corporation had been a REIT in the past five years) is overbroad and was not the intended target of the PATH Acts change to the cleansing rule.[27]

As a result, electing out of REIT status where foreign investors are involved may not be practical, given that the U.S. tax treatment will change dramatically. It is highly likely that the governing documents of the REIT will provide that REIT status will be maintained during the life of the investment.

Generally, de-REITing will result in the entity not being treated as a REIT from the start of the calendar year (January 1). Taxpayers will revoke their REIT election with a statement to the district director for the Internal Revenue District in which the taxpayer maintains its principal place of business on or before the 90th day after the first day of the first taxable year for which the revocation is to be effective.28 As such, there is not a planning opportunity to de-REIT on a specific day during a taxable year; rather, the revocation will essentially be effective December 31st of the last REIT taxable year. It should be noted that a REIT that revokes its REIT election must wait five years to re-elect as a REIT, if so desired.[29]

[A] REIT may consider de-REITing for some or all of the following reasons: (1) to preserve cash; (2) to utilize net operating losses ("NOLs") that have accumulated over time; (3) to generate revenue from lines of business that would otherwise be impermissible.

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MERGER/CONSOLIDATION OF PRIVATE REITS:

It is common for an investment platform such as a private equity fund to use multiple single-asset private REITs to allow for the tax-efficient disposition of its investments with regard to foreign investors.

Commercial real estate has struggled since the Covid-19 pandemic. Many office properties in particular have been incurring significant operating losses, and the bid/ask spread between buyers and sellers, as well as increased debt costs, have caused acquisitions and dispositions to slow to a halt. At the same time, Class A office properties with more

amenities have performed better. Thus, it is common for multiple single-asset REITs in a portfolio to perform differently depending on the asset class and geographic area. Some REITs may be generating significant NOLs (for REITs in particular, NOLs tend to go unused because they are only used after the dividends-paid deduction), making it difficult to service debt, while others are performing well. In such situations, it is prudent to consider combining the over-performing REITs with those that are struggling. One way for this to be accomplished is as follows:

A private-equity fund owner could form a holding company REIT and have the shares of the single-asset REITs contributed to the holding company REIT. The single-asset REITs will be wholly owned by the holding company REIT. As a result, each of the single-asset REITs will become a qualified REIT subsidiary ("QRS"). Each QRS will be a disregarded entity for U.S. income tax purposes (similar to a single member LLC).

Pursuant to the arranged plan, the contributions of the private REITs followed by their conversions into a QRS will be treated as reorganizations under Section 368(a).[30]

With regard to private REITs, it is imperative to retain the NOLs and other tax attributes transfer to the holding company REIT. Given the fact that the ultimate ownership of the holding company REIT and the private REITs that are each now a QRS has not changed, Section 382 related to limiting the use of NOLs in connection with an ownership change of a corporation should not apply to limit the use of the collective NOLs going forward. Additionally, the separate-return limitation year rules under Section 1502 should not apply and, therefore, the NOLs of each private REIT will not be limited to the taxable income generated by the separate REITs/QRS. Furthermore, given that each private REIT was part of a controlled group, Section 384 should not apply in limiting the use of any built-in gain assets against the NOL carryforwards.[31]

Future gains and losses from property qualifying as Section 1231 property will not be netted on a QRS-by-QRS basis but will instead be netted and determined at the holding company REIT level. Even though corporations do not enjoy a rate differential for capital/1231 gain vs. ordinary income, there could still be negative implications that need to be considered. For example, any net 1231 losses will need to be recaptured as ordinary income if there are future gains. This could result in capital losses being unused because the entity cannot use the 1231 recaptured gains against them. This is a very nuanced situation and can be avoided, as necessary, with appropriate tax planning.

An important point to consider is the 100% PHT applicable to REITs and how this may be impacted by consolidating the private REITs into one holding company REIT.

Upon merger/consolidation, any real property trade or business ("RPTB") election under Section 163(j) made with respect to each property will continue to apply at the holding REIT level. Any existing election (or lack thereof) will not impact the ability of the holding REIT to make future elections or impact separate properties.

As opposed to de-REITing, the timing and planning of final returns on merger/ consolidation is more flexible. As mentioned, QRSs are disregarded for federal income tax purposes and, therefore, the merging REITs will file a final federal 1120- REIT return. For simplicity, the merger/ consolidation could be structured on December 31st of any given taxable year so that the holding REIT will effectively start on January 1st of the next year. Of course, to the extent the merger/-consolidation is being done around a specific event, the timing is flexible.

Note that the QRS might have separate state filing requirements, usually specifically for franchise taxes. Prudent care should be undertaken to make sure any merger/consolidation does not significantly increase state taxes.

An important point to consider is the 100% PHT applicable to REITs and how this may be impacted by consolidating the private REITs into one holding company REIT.

As briefly discussed above, REITs that are viewed as dealers of real property may be subject to the PHT on gains recognized on a sale of real estate assets. However, the sale of private REIT shares may not trigger a PHT because this does not involve the sale of REIT assets.[32] Moreover, the Internal Revenue Service has privately ruled on a number of occasions that a sale of assets by a private REIT followed by its liquidation does not constitute a dealer sale subject to the PHT.[33] Lastly, in the event a REIT is considered a dealer of real estate, the Code provides a safe harbor whereby, if met, a REIT will not be subject to the PHT.[34]

Some of the requirements to meet the safe harbor deal with the number and frequency of a REIT's sales of real estate. For example, one such criterion is that a REIT not engage in more than seven sales in a given year.[35] If a private equity fund has a number of private REITs that own multiple properties, each private REIT would be entitled to sell up to seven properties a year and still satisfy this one criterion. If a holding company REIT structure is used, then the holding company REIT is limited to seven sales in total. However, if there are more than seven sales, the REIT can still meet the safe harbor if not more than 10% of the adjusted basis of all REIT assets, or not more than 10% of the FMV of all REIT assets, are sold.[36] Thus, the impact of any REIT consolidation should be neutral.

Separately, not meeting the PHT safe harbor does not mean that the sale(s) automatically are subject to the PHT. In fact, the safe harbor is ignored when analyzing the facts and circumstances and whether a sale would be considered "dealer property."[37] Taking it a step further, the IRS has issued several rulings that take into account the economy and other financial pressures. Accordingly, sales to pay down debt or increase liquidity percentages will all be looked at favorably.[38]

Aside from federal tax considerations, there will be state income and non-income tax implications with any

restructuring/reorganizations, including de-REITing. There are no PHT concerns at the state level, and the same federal corporate income tax implications would apply to state income tax as well. However, there are additional considerations, the biggest of which is NOLs. In a de-REITing scenario, NOLs might be severely limited, depending on the state. California, Illinois and Pennsylvania, for example, cap the usage of NOLs.[39] If merging or consolidating REITs, the holding REIT may not have NOLs available in certain states and/or the income will now be subject to tax in new states (with potentially higher rates). Additionally, there will be the potential for consolidated/combined filings that were not present previously.

On the indirect state taxes, generally there should be no state transfer tax or mortgage recording tax issues. In either a de-REITing or REIT merger/ consolidation scenario, there would be no effective change of ownership, and the property-owning entities should still exist. However, careful evaluation of tax rules in the states where the properties are located needs to be undertaken to ensure there are no negative consequences.

End Notes

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1 See sections 511(a)(1) and 512(a)(1) of the Internal Revenue Code of 1986 (the "Code"). All section references hereafter are to the Code.

2 Sections 512(b)(3)(A)(i), 512(b)(5) and 514(b).

3 A detailed discussion of the income tax issues related to tax-exempt entities is beyond the scope of this article.

4 Sections 871, 881 and 897.

5 As with tax-exempt investors, a detailed discussion of the tax issues facing non-U.S. investors in U.S. real estate is beyond the scope of this article.

6 Provided that the tax-exempt investor did not borrow money to invest in the private REIT, the dividends would not be considered UBTI, even if the REIT has borrowed money to acquire the real estate.

7 However, REIT dividends would be subject to U.S. withholding tax, unless the foreign investor is a foreign government and meets certain other requirements under Section 892.

8 Section 897(l). Qualified foreign pension funds are statutorily defined but are generally pension funds of foreign governments and employers. A QFPF would be subject to U.S. tax on any ordinary dividends received from a REIT (although a select number of income tax treaties, such as with Canada and the U.K., eliminate any withholding tax on REIT dividends paid to pension funds).

9 Often, a private equity fund and foreign investor will form a joint venture in the form of a partnership to hold the REIT shares. The nuances of using this type of structure are beyond the scope of this article.

10 Sections 561 and 562.

11 Sections 857(c)(2) and 1(h)(11)(D)(iii).

12 Section 857(b)(3)(A).

13 H.R. RPT. 2020, 86th Cong. 2d Sess. (1960).

14 Section 856(c)(4)(A).

15 Section 856(c)(5)(B).

16 Section 856(c)(3).

17 Section 856(c)(2).

18 Section 857(b)(6).

19 Section 1221(a)(1).

20 S. Rep. No. 94-938, pt. 1 at 470 (1976). See, Bertonaschi and Drago, Between a Rock and a Hard Place (Maybe) – REITs Deleveraging and the Prohibited Transactions Tax, Real Estate Taxation [formerly Journal of Real Estate Taxation], Fourth Quarter 2023.

21 Section 857(b)(2)(B); Treas. Reg. Section 1.857-2(a)(3).

22 A taxable C corporation would include a trust, partnership or limited liability company that elects to be treated as a C corporation by making a "check the box election" pursuant to Treasury regulation section 301.7701-3(c)(1)(v)(B). While filing a REIT tax return serves as a check the box election for non-corporate entities, many LLCs and partnerships that are going to be REITs will still make a separate check the box election where there is a question whether the LLC or partnership qualify as a REIT from inception.

23 See Levy, Gianou and Rizzo, Tax Considerations For REITs In A CoronavirusDriven Market, April 2020, (authors point out that commercial mortgage REITs considering de-REITing must consider whether losing REIT status will trigger a default on REIT-sponsored collateralized debt obligation or CDO bonds).

24 While Code Section 857 provides for a safe harbor, whether a sale is considered "dealer property" and thus subject to the prohibited transaction tax is based upon facts and circumstances.

25 Section 897(c)(1)(B); Treas. Reg. Section 1.897-2(f)(2).

26 Section 897(c)(1)(B)(iii).

27 See, Richard M. Lipton, Patricia McDonald, Steven R. Schneider, Leah Gruen, Samuel P. Grilli and Diana Myers, PATH Act Improves Rules for Foreign Investment in U.S. Real Estate, Journal of Taxation, June 2016.

28 Treasury Regulation Section 1.856-8(a).

29 Section 856(g)(3).

30 An in-depth discussion of the complexities of the tax-free reorganization provisions of Section 368(a) is beyond the scope of this article. However, see Rev. Rul. 67-274, 1967-2 C.B. 141; King Enterprises, Inc. v. United States, 189 Ct. Cl. 466 (1969); Treas. Reg. § 1.368-2(k)(1)(i)(B)(1).

31 A more detailed discussion of the potential limitations on the use of tax attributes by the holding company REIT against future income and gains is beyond the scope of this article.

32 The PHT could be implicated in situations where a public REIT sells its shares in a private REIT; however, it is arguable that such sale should not be treated as a dealer sale.

33 See PLR 201844003, PLR 201707010, PLR 201609004, PLR 201640007, PLR 201340004, PLR 201346005. While private letter rulings are non-binding on the IRS and are not to be relied upon as precedent, they do provide insight into the Internal Revenue Service's thinking and approach to a particular question.

34 Section 856(b)(6).

35 Section 856(b)(6)(C)(iii)(I)

36 Section 856(b)(6)(C)(iii)(II) and (III).

37 Section 856(b)(6)(F).

38 PLR 200945025; PLR 200953018; PLR 201315004; PLR 201340004.

39 See Jamie C. Yesnowitz, Chuck Jones, Patrick K. Skeehan, States continue to tweak NOL provisions, The Tax Advisor, February 2025.