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Choice of Entities for Holding Real Estate: Real Estate Investment Trusts

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CHOICE OF ENTITIES FOR HOLDING REAL ESTATE: REAL ESTATE INVESTMENT TRUSTS*

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Let's talk about real estate investment trusts. First of all I would like to discuss what they are and why you should be interested in real estate investment trusts. Real estate investment trusts (REITs) are a cross between a partnership and a corporation. They share some of the benefits of both. Income passes through without being taxed at the entity, the REIT level, and thus is taxed only once at the shareholder level.

The real estate industry is probably one of the most maligned industries that we have, and REITs clearly the most maligned entity. If a partnership goes down the tubes, no one talks in terms of the partnership industry going down the tubes. If a corporation goes belly up, we don't talk about the failings of the corporate investment vehicle. For some reason the problems that some REITs have faced over the last couple of years have been tied to the industry and therefore the industry has been marked for doom. Frankly, because of this the current market for REIT's is small. There are, nevertheless, some real reasons for you to know about real estate investment trusts. They may be a little esoteric right now but I hope they are not. REITs are like butterfly spreads for those people who deal in taxes. You have to know about them. You don't use them very often but when you need them they can be very handy. Therefore, we are going to talk about REITs.

For the privilege of not having to pay tax, in other words, having integration, as President Carter would refer to it, a REIT has to pay a price. That is, there are certain restrictions on the kind of income that REITs can generate. Also, a REIT cannot retain income. It must distribute 90% (95% after 1979) of its income to its shareholders.

Furthermore its income must be passive income—it must be a passive entity. Congress said that so long as the activities are passive, the REIT will be allowed to pass the income through to its shareholders without paying tax at the entity level. That means it cannot actively involve itself in businesses. If it owns real estate, such as an apartment building, it must have a property manager; it cannot operate that property directly. If the REIT owns shopping centers it has to be very careful how its structures the leasing. The REIT cannot share in the net income of tenants but it can share in the gross income. This is a distinction drawn from the passivity test. The REIT's share of gross can be based on a variety of devices. It can be a percentage over a certain dollar level. For example, if a REIT owns the shopping center it could receive

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the regular rent plus 2% of sales after the first million dollars worth of sales. As an alternative the income could increase in steps, say after the first million in sales from the shopping center, the REIT will receive 2%. If sales are 5 million dollars it will receive 5%. As another alternative the percentage could vary depending upon the income source. For instance, in the case of a casino, there are several different businesses, the gambling take, restaurant operations, a hotel, and a bar side. The REIT could take different percentages from different parts of the casino as long as they are based on gross. But no matter how the income is calculated, 90% of the income must be from interest, rents, dividends, etc. Additionally, 75% of the income must be real estate oriented. Various categories of income are treated differently. I don't think it does a lot of good to dwell on some of the categories but I will say this much, that REIT income is not taxed to the extent that it's ordinary income. Capital gains will not be taxed if it is distributed to the shareholders (at capital gains rates). Since the distribution of capital gains is elective, the REIT can opt to retain the income and have the capital gains tax levied at the REIT level (the entity level).

There are two other types of income that a REIT can have, foreclosure property income and prohibited transaction income. Briefly, if a REIT acquires troubled properties by foreclosure or deed in lieu of foreclosure, a REIT can elect to deal with the property in a more active mode. For the ability to do this, income derived from that property is going to be subjected to a regular corporate rate of 46%. There is also a provision that says that if a REIT sells property in an ordinary course of business (a prohibited transaction) the REIT will be subject to a 100% tax on any profit. Even with this tax, there are some times when it's to the REIT's advantage to hold property for sale. For instance, if it owns an apartment house and has a cigarette vending machine in the lobby for the convenience of the tenants, and if the REIT receives some of those receipts and there is a profit on those sales, that profit would be taxed at 100% rate.

In addition to the income rules, a REIT is also subject to asset tests and organizational requirements. Failure to comply with these tests can cause disqualification.

The REIT industry problems have bottomed out, and while the industry will continue to have some problems, it is viable. Last year there were $75,000,000 worth of real estate share offerings. There are two REITs offerings pending before the SEC right now. There are several intrastate REITs presently available either in the offering stages or on the drawing boards. I am aware of other REITs planning about a $150,000,000 worth of stock offerings. So there are still people who believe in REITs. In prior years one talked in terms of two kinds of REITs: (1) equity REITs where the REIT would specialize in equity ownership and (2) a mortgage REIT, where the predominant assets are loans, generally shorter term loans such as construction lending, gap lending, etc. These mortgage REITs are the ones that got into trouble. The equity trusts were by and large not hurt by the events of the last 5 or 6 years. There are mortgage REITs that have become REITs when loans were not repaid and the REIT was forced to foreclose.

For the next few years, the REITs are often going to be used in specialty areas. We are starting to see them in second trusts now that interest rates are going up. There are three second trust REITs under consideration at this time. This use of REITs will allow the small investor to become a part of the second mortgage market. The share yield at this time is being projected somewhere around 12% to 13%. That is after all expenses, but only allows for a few foreclosures. There are also some specialty types of REITs that are looking at warehouses, mini-warehouses, marinas, parking garages, casinos—areas in which banks cannot or really do not want to lend money.

There are several other areas in which REITs should be carefully considered. The first is holding real estate for pension funds. Pension funds, if they invest directly in real estate and leverage it, are subject to an unrelated business tax. In other words, to the extent they use debt to finance property, they are subject to tax on the income from the property. If instead they buy that leveraged real estate through a REIT, it flows up through the REIT and into the pension fund on a tax free basis. The second area is foreign investment in United States real estate. There is a possibility of coming out with a very small tax on the operating income from the real estate by having a REIT hold the property and flow the income into a variety of foreign arrangements.

Another area which is being closely studied is the use of REITs by industry and manufacturing businesses that are heavily real estate oriented. For instance, why doesn't General Motors set up a sister REIT, put all its real estate into it, pay a rent of 6, 8 or 10% on that real estate. Income could conceivably come out of General Motors tax free. It could be a REIT whose shares piggyback with General Motors shares. This concept is being looked at by several companies.

There are many REITs around with very large net operating losses. There are also, as a result of the very good real estate market during the last couple of years, some entities that have a tremendous amount of income either about to be earned or with the potential to be earned in the future, from land development, condominium conversions and home building.

We have been working with a couple of REITs, attempting to use their net operating losses through the acquisition of these profitable entities. The REITs could effect this by giving installment paper to the present owners of these companies and converting what would be ordinary income into capital gains. With the new capital gains rates this approach may be worth serious consideration. There are some problems, but, I believe it can work.

The coming year is shaping up to be an interesting one from a variety of standpoints and I think the REIT industry is prepared for whatever happens. The weak REIT have already worked out their problems or they're not paying any interest on their loans so if interest rates go higher they shouldn't be affected. The equity REITs have in large part developed liquidity over the last two years so they are in pretty good shape. REITs are not going to be as affected by any slowdown as they were in the early 1970's. The REIT, we think, will continue to have a place in the area of real estate financing and ownership.