Podcasts | October 3, 2025

# Key Advantages of Using REITs by Funds for Tax-Exempt Investors

## The Tax Blueprint: Structuring Funds, Joint Ventures, and REITs


**SPEAKERS**

Saba Ashraf | Aresh Homayoun | Thomas D. Phelan


Welcome back to "The Tax Blueprint: Structuring Funds, Joint Ventures, and REITs." In the second episode of our three-part series, hosts Saba Ashraf, Aresh Homayoun, and Tom Phelan explore the unique advantages real estate funds can offer to tax-exempt investors – including pension plans, university endowments, private foundations, and IRAs.

This episode discusses key strategies for tax-exempt investors to maximize their returns, including the use of REITs as a "blocker" to avoid UBTI, the implications of debt-financed income, and the nuances of the fractions rule.

Stay tuned for upcoming episodes which will cover the advantages of REITs for foreign investors in funds.

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**Saba Ashraf (00:05):**

Thanks for joining us on this episode of the *Tax Blueprint Structuring Funds Joint Ventures and REITs*. We're continuing with our series on the benefits of the use of REITs by funds. On our last episode, we covered the benefits to U.S. individuals, including the GP stakeholders. On this episode, we're covering the potential benefits to tax exempt investors. I am joined once again by my partners, Aresh Homayoun and Tom Phelan, and I am Saba Ashraf, all from the tax group of Troutman Pepper Locke.

**BACKGROUND**

Tax exempt investors provide considerable capital to funds and they're comprised of a range of investors including pension plans, university endowments, private foundations, and IRAs. So the capital is very valuable and the sponsor wants to make sure that the returns on their investment are maximized. So generally these investors aren't subject to income tax. However, if their income's considered to be unrelated to their tax exempt purpose — their charitable, educational other purpose — then it's considered unrelated business taxable income, UBTI, and it's subject to income tax.

**(01:14):**

For most of them, it's a 21% rate. For certain tax exempt entities that would be taxed as trusts, it's currently a

37% rate. So our goal is to maximize as much as possible income from the fund that is not subject to that 21% or 37% tax rate. So UBTI has some pretty big exceptions including rents from real property and gain from selling real property. However, real estate investment funds that do not use a REIT in their structure can potentially generate a significant amount of UBTI, even though their income consists in large part of rents from real property or gain from the sale of real property. And the reason for that is another rule that says that if otherwise tax exempt income is generated from assets for which there's acquisition and indebtedness, then that otherwise tax exempt income becomes UBTI. And the amount of the UBTI is proportionate to the amount of the debt on the assets generating the income. So acquisition and indebtedness includes debt that was incurred when acquiring or improving the property, which is generating the income. So in the case of real estate, most real estate is held through partnerships or LLCs, and most of it does have considerable leverage. It is acquired with a considerable amount of acquisition and indebtedness, and that leads to a lot of income from real estate funds potentially being exempt from UBTI. And the use of the REIT can minimize that. So now I'll turn it over to Tom to talk about that.

**HOW REITS MINIMIZE UBTI**

**Tom Phelan (02:58):**

Thanks Saba. So there are two primary ways that holders of REIT shares generate taxable income, and that's receipt of REIT dividends and the sale or disposition of shares at the REIT dividends. And other items like interest and rent like Saba mentioned, are specifically excluded from being taxed is UBTI. So generally speaking, these items just won't produce UBTI. The same is true for the gain from the sale or exchange of property other than certain carved out inventory like items to the point that Saba was making before. With respect to debt financed income. Both of these exceptions for REIT dividends and sales of shares of REITs remain subject to the debt financing rules for UBTI. That, is if debt was used to acquire the REIT shares, then a proportion amount of the dividends on the shares and gain from their disposition would still constitute UBTI. So to avoid the debt financing issues that could potentially create UBTI leverage and debt generally needs to be drawn down below the REIT so that the REIT is a corporation from a tax standpoint doesn't allow that debt to be attributed to the shareholders of the REIT.

**(04:17):**

Similarly, tax exempt shareholders should avoid incurring debt to acquire the REIT shares so that the REIT shares aren't treated as debt financed. Another way of thinking about this is that a REIT technically being a corporation for tax purposes acts like a blocker for UBTI, just like a regular C corporation would, but with the benefit of avoiding the corporate double tax because REITs generally aren't subject to their RET taxable income if they distribute it to their shareholders. An additional exception where UBTI can still apply is in the case of a pension held REIT, very generally a REIT is pension held if it needs to look through a pension investor to avoid being closely held and either a pension investor owns more than 25% of the REIT's interest, or one or more pension. Investors that own 10% or more of the REIT collectively own more than 50% of the REIT. If the REITs treated as being pension held, then tax exempt investors owning 10% or more of the REIT would need to treat a portion of REIT dividend income as UBTI. With that, I'm going to pass it over to a RH to discuss the fractions rule.

**FRACTIONS RULE**

 

**Aresh Homayoun (05:29):**

Thanks, Tom. So as you all both mentioned, UBTI includes income from debt finance property, and given that real estate funds typically finance real estate with debt, it's generally expected that a significant portion of the fund's income may be characterized as UBTI. Fortunately, there is an exception from UBTI for certain qualified organizations, and this exemption is called the fractions rule. Now, the fractions rule does not universally apply to all tax exempt entities. It only applies to what are called qualified organizations and qualified organizations for these purposes are educational organizations including university endowments, certain pension trusts, and also certain church retirement plans. Importantly, individual retirement accounts are not included in this category. And so to qualify under the fractions rule, the fund would have to satisfy to three requirements. The first is that a qualified organization cannot be allocated a percentage share of overall partnership income for any partnership taxable year greater than the qualified organization's fraction rule percentage and fractions rule percentage.

**(06:48):**

For these purposes, it's the qualified organization's percentage share of overall partnership loss for the partnership taxable year in which it's percentage share of overall partnership loss will be smallest. And in addition to that, the other requirement and the one that in my view comes up the most often in practice and is probably the most troublesome, is that partnership allocations must have substantial economic effect and substantial economic effect, as you all probably know, appears in section 704(b) of the Code. And it's a rule for allocating income among partners. And the issue that comes up is that in real estate funds, substantial economic effect generally requires a partnership to liquidate in accordance with positive capital accounts. And that's usually not, at least in my experience, what you find in a real estate fund because in a real estate fund you have targeted allocations. So the question is, is that do targeted allocations have substantial economic effect?

**(07:51):**

And it depends on which tax practitioner you speak with. Different people feel differently about it. I think at a minimum it's a gray area. It's unclear. And the issue with fractions rule in a real estate fund context is that if you really want to have certainty that you're satisfying the fractions rule, you're really going to have to have substantial changes to the partnership agreement to make sure that you're complying with the fractions rule. And even if you do that, there are other issues that come about as well. Preferred returns, management fees, other types of events also really have to be looked at closely from a fractions rule compliance perspective. And usually where you end up is that you talk to your accountants, you talk to return prepares, and you just get comfortable as you can to that the fraction rule is going to apply. The problem is that at least in my experience, that's not a high level of comfort.

**(08:49):**

You can get comfortable, but there's going to be risk that the IRS could come in and challenge and with fractions rule in a partnership context. That's the drawback, is that it's a little bit of a gray area. There are a lot of unanswered questions with targeted allocations and substantial economic effect being at the top of the list. That's to be compared with the REIT, which as Tom and Saba described, it's black letter law. The REIT is going to pay dividends out and dividends again as black letter law are exempt from UBTI. So yes, you've got to go to the additional cost and inconvenience and effort of forming a REIT. There is complexity and other downsides involved, but if you have a fund that has a significant tax exempt investor or institutional investor component, then I think that a REIT is worthy of consideration. And a lot of the more sophisticated investors are actually going to ask for a REIT blocker or some other form of blocker because again, it's so difficult to get comfortable with fractions rule at a high level of comfort. So I think those are the considerations you have to look for if you want to rely on the fractions rule or you want to use a re.

**FURTHER THOUGHTS: FRACTIONS RULE VERSUS REIT**

**Saba Ashraf (10:02):**

I think the fractions rule maybe is a little easier to work with if you're not in a fund with multiple investors trying to basically address the needs of many different tax exempt investors. But where you have maybe a joint venture with one significant tax exempt investor that's clearly covered by the fractions rule, that might be more useful in that case. But in a fund setting where you have multiple investors, like you said, Aresh, it's only going to help out university endowments, certain pension plans and certain church retirement plans. So that leads pretty broad categories of investors, tax exempt investors who aren't going to be covered. I think often it seems like the main push for the fractions rule over the REIT might be maybe the perception that compliance with the fractions rule will avoid the cost associated with REITs. But as we talked about in our last episode, certainly there are costs of forming and implementing a REIT in the structure. However, there are also savings to be had by that, including savings in compliance and issuances of K-1s. So perhaps the costs are not as high as perceived, and if there are multiple investors, then there probably is going to be some costs associated with ensuring that the fractions rule is complied with at all times. I think that brings us to a wrap of this episode. So we will hopefully see you on our next episode where we address the final category of investors, which would be foreign investors that invest in funds that use a REIT.

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