***The Tax Blueprint: Structuring Funds, Joint Ventures, and REITs* — Key Advantages of Using REITs by Funds for US Individuals and GP Stakeholders**
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Saba Ashraf:

Welcome to the first episode of *The Tax Blueprint*: *Structuring Funds, Joint Ventures, and REITs*. My name is Saba Ashraf, a partner in the tax group here at Troutman Pepper Locke. And I am joined on this podcast with two of my partners, Aresh Homayoun and Tom Phelan. We're starting off our podcast with a three-part series on the benefits of the use of REITs by funds to particular groups of investors.

Today, on this first of the three-part series, we're addressing the benefits to U.S. individuals, including in particular the individuals that might be members of the GP entity. In the next two series, we'll cover other groups of investors such as tax-exempt investors and foreign investors.

By way of background, the structure that we're generally discussing is one in which the fund is a tax partnership. And the tax partnership, that's where all the investors are coming in, and that's the entity in which the GP holds an interest, its carried interest. And that fund has below it a REIT. The fund owns 100% of the common interest of the REIT and makes all its investments through the REIT. That's sort of the structure we're working with.

PREVIEW OF TOPICS COVERED

The benefits we're hoping to cover are, one, the Section 199A, reduced tax rate, on some REIT dividends. Two, potential lower state tax rate applicable to some income of the fund for some individuals. Three, decrease compliance costs for investors and the fund. Four, greater ease with which some deductions may be calculated and used to offset income. And finally, we wanted to focus specifically on the GP in particular.

With that, I will turn it over to Tom to describe generally the taxation of REIT income to fund investors.

GENERAL TAXATION OF REIT INCOME AND DISTRIBUTIONS

Tom Phelan:

Thanks, Saba. So, this is to set the stage for the 199A benefit that we're talking about. What is a fund getting when it invests in a REIT? What is a REIT at a very basic level? Generally speaking, a REIT is a trust or corporation that would otherwise be taxable as a C corporation if it hadn't elected to be taxed as a REIT. Very generally, assuming that the REIT complies with the myriad requirements to qualify as a REIT associated with its structure, asset ownership, generally, REITs are investing in real estate-based assets. And its operations, like distributing a

certain amount of REIT taxable income, an investor in a REIT, like the fund, can typically achieve a single layer of federal income tax because the REIT itself gets a deduction for dividends and distributions paid to its shareholders, like the fund. And generally, doesn't end up paying federal income tax if it distributes all of its REIT taxable income.

In short, generally, a REIT won't be subject to federal income tax on the taxable income that it distributes to its shareholders. It's just the shareholders that are taxed on the distribution. To the extent that a REIT doesn't distribute all of its earnings to the shareholders, it remains subject to corporate federal income tax on anything that it hasn't distributed.

With respect to distributions that are made to the holders of REIT shares, the fund in this case, how are these generally taxed, and what different types of distributions can we have? The fund would generally be required to include, as ordinary income, distributions that are made out of the REIT's current or accumulated earnings and profits. These distributions typically would be taxed at ordinary income rates at the level of individual investors at the funds. Assuming it's going up to individuals, the top marginal rate is 37%. However, as Aresh will discuss a little bit later with respect to this 199A Deduction, that number can be reduced substantially for years starting after December 31st, 2017.

For REITs with significant operating income, like a mortgage REIT or a REIT that you know holds real estate and is renting it out generating significant rental income, that generally means that a lot of the distributions that are coming out of the REIT to the fund would be taxed ordinary income similar to the way that rental income or interest income would be taxed ordinary income rates if the individual investors were investing directly in the real estate or in a loan.

Dividends paid by a REIT won't qualify for qualified dividend income, which everyone's probably familiar with. That's income that's taxed at like a 20% rate for capital gains. Generally, that's income or dividends paid by a domestic C corporation or certain foreign corporations. The reason for this, that REITs aren't eligible for this, is because the REIT itself was never taxed on the income that it's distributing to its shareholders. So, it just doesn't get the benefit of being able to pay qualified dividends like other domestic entities that are corporations.

However, the REIT still can get the preferential rate for qualified dividend income with respect to dividend incomes that the REIT itself receives that are attributable to kind of non-REIT corporations that the REIT owns, like a TRS,, if the REIT has TRS's, or that are attributable to earnings that the REIT has already paid tax on. For example, if the REIT doesn't distribute all of its earnings and pays corporate-level tax, it can pay QDI dividends to the extent it later distributes that income out.

REITs can also make distributions that are designated as capital gain dividends. Effectively passing capital gain recognized at the REIT level or realized at the REIT level out to the shareholders. Those capital gain dividends are generally treated as long-term capital gains passing through to the funds without regard to how long the fund has held its interest in the REIT. Generally, you have the kind of one-year holding period associated with long-term capital gain.

If the REIT makes a distribution in excess of its earnings and profits, if the distribution doesn't exceed the investor or the shareholders, the fund, in this case, is adjusted basis in the REIT

shares. That distribution comes out on a tax-free basis to the extent of that basis that the shareholder has in the REIT. And then that basis is reduced. If the distribution was in excess of the basis, then there's capital gains.

As we mentioned above, the single-layer of tax doesn't always apply. The REIT can retain earnings and pay income tax on it so long as it complies with general requalification requirements, like the requirement that the REIT generally distributes 90% of its REIT taxable income. Notwithstanding the ability of the REIT to kind of achieve this single-layer of federal income tax, basically passing through its income to the shareholders while avoiding paying tax itself. The REIT doesn't operate as a pure pass through. Losses that are recognized by the REIT are never going to be passed through to the shareholders. Those losses generally are either used to offset current income or carry forward at the REIT level.

Those are kind of general outline of the rules associated with the type of distributions that the fund might receive from the REIT. And even if you have a REIT where the vast majority of the distributions are kind of ordinary REIT distributions that we would typically think of as distributions that are passing through rental income or interest, the 199A Deduction that Aresh is going to discuss next can offer a significant benefit and reduction in that 37% rate. With that, I'll hand it over to Aresh.

REDUCED TAX ON ORDINARY REIT DIVIDENDS UNDER SECTION 199A

Aresh Homayoun:

Thanks, Tom. Yes, that 199A Deduction is one of the most significant benefits of a REIT in the case of domestic shareholders. And the deduction was enacted as part of the Tax Cuts and Jobs Acts of 2017. And what the deduction effectively does is that it provides a 20% deduction for income from certain qualified trades or businesses, and that includes partnerships and S corporations.

Now, that sounds fairly straightforward, but the rule is subject to some significant restrictions and limitations. There are restrictions on the nature of the trade or business and there are also wage limitations. And if you look at the regulations under Section 199A, they're actually voluminous. I think they were like 70 or 80 pages long. This is an extremely complicated provision. But the beauty of using a REIT in the structure is that you're not subject to any of those restrictions, not any of the wage limitations or the qualified trade or business limitations. And that's because in the case of a REIT, shareholders in a REIT are entitled to an automatic 20% deduction without having to be subject to any of the wage limitations or other restrictions.

If you have an investor that's subject to tax at the highest federal rate, which is currently 37%, they get an automatic 20% deduction and end up paying 29.6%. And so that is a significant benefit compared to a structure in which there is no REIT. Because if there's just a pure partnership structure where you have investors coming in at the partnership level and the partnership directly owns the property, then you're in a situation where you have to go through all these various hoops and limitations that are contained in the rules. And in my experience, the 20% deduction ends up being something less. And in some cases, I've actually seen it be zero. When you've got a REIT in the structure, you have that deduction, and it's automatic, and that's a significant benefit.

Now, one significant planning consideration, from a planning perspective, one drawback has been that, until very recently, this provision, Section 199A, was set to expire at the end of 2025. As I mentioned, it was enacted as part of the Tax Cuts and Jobs Act of 2017. But like many of the other individual provisions in that piece of legislation, it was temporary and it was scheduled to expire at the end of this year. But under the One Big Beautiful Bill Act that was enacted into law this summer, that provision is now permanent. And so, now, I think that there's a lot more certainty going forward with respect to planning and knowing that that deduction is going to be available. That's a general discussion of Section 199A.

And I think we may be able to jump to the next topic now, which is state tax filings in the context of REIT structures. And I think that the way I compare and the way I look at this is that I compare REIT structures with partnership structures. And if you have a situation where you have a partnership without a REIT that owns various properties, it's not a great situation from a compliance perspective, as far as individual investors are concerned in state tax filings. And that's because not only does the partnership have to file tax returns in multiple states, but so do the individual limited partners. And so if you have a partnership that owns properties in multiple states, that's a lot of K1s, and that is a lot of different state filing requirements.

STATE TAX COMPLIANCE

Now, state taxes are always – there's a lot more to it than that. And this is a general overview, because you can have composite returns in some states. But not all states allow composite returns. It's a state-by-state situation. And in general, with a partnership without a REIT, you have much more cumbersome filing obligations. And that's to be contrasted with a REIT structure, where if you've got a fund that owns the properties through a REIT, then what's basically happening is that, as Tom mentioned, there is dividend income. And that dividend income is being paid from the REIT up to the partnership. And then the partnership then turns around and provides a K1 to the investor. Very simple K1 that reflects the amount of the dividend income.

The benefit of this is that the individual partners are only going to be filing tax returns in the state of their domicile, their state of residence. They're not going to be filing tax returns in all the various other jurisdictions in which the fund owns properties. That also is a significant benefit. And I think Tom may have some additional thoughts regarding some of these compliance matters.

Tom Phelan:

Yeah. Thanks, Aresh. I think that's a very nice summary of where that stands with the idea that, rather than kind of going out and having to receive a K1 from various underlying partnerships and file in different states if you need to, if you're waiting on a K1 from one investment but have received the K1s and the other investments. Having everything consolidated at the REIT level may also further simplify things because it could effectively accelerate the ability to get the K1s. Or at the very least, just kind of make it clear when you have all the information that you need to file your return, so you're not waiting on information from various sources.

And as Aresh noted, this helps to kind of simplify tax reporting for the individuals in the funds. And to some degree, this level of simplicity that the shareholders get up at the fund level may

help offset, to some degree, some of the additional complexity that goes along with an investment in a REIT, right?

One thing that people worry about when they're investing in a REIT is, well, if I'm investing in a REIT, then I need to deal with all of the general compliance requirements associated with setting up my REIT, right? It needs to have a certain number of shareholders. We need accommodation shareholders. We need to make sure that we make the REIT election. And then from an operational standpoint, it can be somewhat cumbersome to comply with REIT requirements in the sense that you need to engage in REIT testing each year with respect to income assets and distributions. Even though there's more compliance at the REIT level, the simplicity up at the shareholder level or at the LP level in the fund may help offset, to some degree, some of the additional compliance costs that are incurred at the REIT level itself.

Saba Ashraf:

Yeah. We always hear clients in particular that have not previously used a REIT structure in their fund have concerns about the cost of forming a REIT and then ongoing compliance costs relating to tax returns. Just ongoing sort of maintenance of records and compliance with retests, which are all valid concerns. But sort of the counterpoint to consider with that, in connection with that, the corollary to that also is that, one, the investors will have a much lower cost of compliance because the K1 that they receive is much simpler. And also, the REIT's compliance cost as far as issuing complicated K1's sourcing income from many states to all their investors, those are going to be significantly decreased if that's going away because all the investments are made by the REIT. That's just something to consider in the big picture when considering the cost burdens of forming and maintaining a REIT.

Just to recap, we went through the Section 199A benefit and contrast that with, "Well, what if I invest in a regular real estate fund, won't I get the 199A benefit?" And yes, you possibly could, but there are lots of sort of hurdles to that, including outside the REIT context, the 199A Deduction is limited to qualified business income, which to determine whether you have qualified business income, you have to determine if there's a qualified trader business. That test goes out if your income is just from the REIT itself, from REIT dividends.

If you're not in a REIT context, you also have to determine – you have limits on your 199A Deduction that relate to the W-2 wages paid by the businesses, or 50% of W-2 wages, or 25% of the W2 wages, plus 2.5% of the business's unadjusted basis in its qualified property. You don't have to reach those questions. It's much more of a no-brainer sort of. And I think that is pretty appealing to not only the investors but also the REIT itself, so that it does not have to engage in sort of establishing the answers to those.

SIMPLIFICATION OF ABILITY TO TAKE CERTAIN DEDUCTIONS

A couple of other things I wanted to point out are that using a REIT may make it so that certain deductions are simpler to take. For example, the 30% interest expense deduction under section 163J. While that is calculated at the partnership level, any excess business interest expense is allocated to the partners and carried forward by them individually and not the partnership. If you have a fund that doesn't use a REIT, you'll have those rules applied. In the case of a REIT, the REIT would have much greater flexibility in claiming the deduction and carry forwards. The sort

of 163J limit and other deductions that may be more complicated to pass through to investors sort of fully can become simpler if a REIT is used.

PASSING THROUGH LOSSES

At the same time, one point to note is that – and I think, Tom, you talked about this already. But unlike a partnership that doesn't use a REIT, the REIT can't pass through losses to its investors. Those losses are the REIT's losses. And the investor basically can't use them. Most LPs and real estate funds are significantly limited in the losses they may be able to claim that flow through from the fund by passive loss rules and other rules. That said, if the investment strategy of the fund is focused on the claiming of deductible losses by investors, then the REIT may not make sense. In that circumstance, it might make sense to talk through other strategies more fully.

FOCUS ON GPs

And before wrapping it up, I wanted to highlight in particular the benefits to the GP. There are a lot of benefits to the investors, but there are to the GP as well. If this is a fund where most of the income is going to be ordinary sort of operating income like the type that a mortgage rate might have, lots of interest, or if there's significant rental income, and if those two sources of income are going to fill up the GP's carry, then the use of a REIT would mean that instead of the GP's carry being taxed at 37%, it'll be taxed at 29.6%, which is a significant benefit.

And the other benefit for GPs in particular to consider is that if they reside in a state that has very low or zero tax-rate, income tax rate, which GPs may have engaged in tax planning specifically to achieve that low state income tax rate. If they are residents of that state, then using the REIT structure would allow them to be able to source the income to their state of residence, which would allow them to maximize their state tax strategy.

With that, we'll wrap up this episode of our podcast. Thank you for attending. And please look out for our second in this series where we'll focus on the benefits to tax-exempt investors. Thanks for joining us.

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