# Using Private REITs to Minimize UBTI in Real Estate Investment Funds

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**In this article, the authors discuss the issues that arise out of the use of a REIT as a mechanism for minimizing UBTI to investors in real estate funds.**

A significant issue confronting pension funds and other tax—exempt investors in private real estate equity funds is the extent to which the funds' activities may generate unrelated business taxable income (''UBTI''). This issue is of particular significance in the case of real estate funds because real estate investments are traditionally highly leveraged and gross income from debt—financed property constitutes UBTI.[1] Although UBTI can be eliminated if the federal income tax allocation provisions in a fund's organizational documents follow the ''fractions rule'' set out in Section 514(c)(9)(E) of the Internal Revenue Code (the ''Code''), compliance with the fractions rule will benefit only pension funds and university endowments. An alternative method of eliminating the generation of UBTI is to structure the real estate investment fund as a private real estate investment trust (''REIT'') or to include a REIT as a separate component in the ownership chain of the fund and its investments.[2] Although a REIT, unlike the pass—through entities normally used for real estate funds, is a taxable entity, it is eligible for deductions for all dividends that it pays out and—because a REIT is required to distribute substantially all of its taxable income[3]—it will typically owe little or no income tax.

Although the REIT may be a useful tool from the perspective of minimizing UBTI, the requirements applicable to REITs under the Code can significantly complicate the formation, operation and administration of a fund. Because the Code requires REITs to have at least 100 investors, use of the REIT structure will complicate the sponsor's efforts to ensure that the fund will not be characterized as an ''investment company'' that is required to register with the Securities and Exchange Commission and satisfy the other requirements of the Investment Company Act of 1940. The requirements of the Code that a REIT derive a minimum percentage of its income from real estate, that a minimum percentage of its asset value be composed of real estate assets and that it distribute substantially all of its taxable income can inhibit the operational flexibility of the fund. The Code requires that interests in a REIT be freely transferable (subject to certain restrictions discussed below which are expressly permitted), which is inconsistent with the strict control over transferability typically exercised by fund managers; at the same time, care needs to be taken that transfers by investors do not result in a violation of the REIT rules regarding concentration of ownership.[4] The REIT structure may also limit the ability of the fund to dispose of a property as it sees fit, lest the disposition be deemed a ''prohibited transaction'' under the REIT rules—a result that would cause any gain from a disposition to be subject to a 100 percent tax. There are a number of steps that can be taken to address each of these issues.

## *Unrelated Business Taxable Income*

Sections 512(a) and 513 of the Code define UBTI as (i) gross income received by a tax—exempt entity from the conduct of a trade or business that is not substantially related to the exercise or performance by such tax—exempt entity of the purpose or function constituting the basis for its tax—exempt status, less (ii)

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deductions that are directly connected to such unrelated trade or business. UBTI is subject to federal income taxation and, depending on the jurisdiction, may be subject to state and local income taxation. The Code specifically provides that UBTI includes a ratable percentage, based on the percentage of leverage, of gross income (less the same percentage of applicable deductions) derived from debt—financed property where there is ''acquisition indebtedness.'' Acquisition indebtedness would include most mortgage financing.[5] If a real estate fund is structured as a pass—through entity for tax purposes—as the vast majority of funds are, so that income tax will not be payable at the fund level—then a portion of income derived from debt—financed investments by the fund will constitute UBTI to its tax—exempt investors, although pension funds and university endowments can eliminate UBTI if the fund complies with the ''fractions rule.''

Because Section 512(b) of the Code specifically excludes dividends from UBTI, a real estate investment fund structured as a private REIT, or a fund that owns its properties through a REIT subsidiary, may be used to ''cleanse'' UBTI because income from a REIT is distributed to its investors in the form of dividends.[6] Another potential REIT structure, more useful for funds with both taxable and tax—exempt investors as discussed below, involves a REIT through which the tax—exempt investors (but not taxable investors) hold their interests and that in turn holds interests in the fund.

## REIT Qualification

In order to qualify as a REIT, an entity must satisfy two real estate—related income tests (the ''Income Tests'') and one real estate—related asset value test (the ''Asset Test''):

(a) at least 75 percent of the gross income of the REIT for each taxable year, other than gross income from prohibited transactions,[7] must be derived directly or indirectly from investments relating to real property including, without limitation, rents from real property, interest on obligations secured by mortgages on real property or on interests in real property, gain from the disposition of real property, distributions on and gain from the disposition of transferable shares or transferable certificates of beneficial interest in other qualifying REITs, and income and gain derived from foreclosure property (''Real Property Gross Income''),

(b) at least 95 percent of the gross income for each taxable year, other than gross income from prohibited transactions, must be Real Property Gross Income or derived from dividends and interest and gains on the sale or disposition of stock or securities and

(c) at the close of each quarter, at least 75 percent of the value of the REIT's total assets must be represented by real estate assets, cash and cash items and government securities.[8]

In addition to satisfying the Income Tests and the Asset Test, a REIT must: (1) be a corporation, trust or association that would be taxable as a domestic corporation but for the REIT provisions of the Code (a ''taxable entity''),[9] (2) be managed by one or more trustees or directors, (3) have its beneficial ownership evidenced by transferable shares,[10] and (4) have at least 100 shareholders for at least 335 days of each taxable year (the ''100 Shareholder Test'').[11] In addition, not more than 50 percent of the ownership of the REIT may be held by five or fewer individuals (the ''Closely Held Test'').[12]

## Potential Structures

The simplest way to use a REIT to minimize UBTI to fund investors would be to structure the fund as a taxable entity that qualifies as a REIT. However, the requirement that the REIT be managed by one or more trustees or directors will make the use of traditional fund structures—limited partnerships and limited liability companies—impracticable. One solution to this problem is to structure the fund as a partnership or other pass—through entity with a corporate entity (to be qualified as a REIT) as a subsidiary of the fund (referred to here as the ''REIT Subsidiary Structure''). However, the use of the REIT Subsidiary Structure, or the use of a corporation or trust as the fund itself, would be disadvantageous to the taxable investors in the fund because any losses generated by the fund would be ''trapped'' in the REIT and would therefore be unavailable to taxable investors. In addition, in the case of funds which invest in foreign real estate, the use of these structures would not allow taxable investors to take advantage of the foreign tax credit available under the Code.

Under a third structure (the ''REIT Parent Structure''), tax—exempt entities would invest in a REIT that in turn would hold limited partnership or membership interests in the fund, while the taxable investors would hold interests in the fund either directly or through a separate vehicle.[13] Taxable investors would then receive the same tax treatment as if the REIT structure had not been put in place. However, as described below, the use of the REIT Parent Structure enhances the risk that the REIT will be characterized as an ''investment company'' under the Investment Company Act because the ''real estate'' exemption afforded by Section 3(c)(5)(c) of the Investment Company Act will less likely be available.

## Operational Issues

The requirements imposed by the Code for REIT qualification will reduce the operational flexibility of the fund. Compliance with the Asset Test and the Income Tests limits the types of investments the fund can make



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and the types of income it can receive. For example, the asset value of a real estate management company will not qualify for the Asset Test and income generated by a real estate management company or a hotel, or fee income derived from the performance of certain non—real estate—related services for residential or commercial tenants, will not qualify for the Income Tests. Moreover, income that does not qualify for the Income Tests, if in excess of the caps set forth in the REIT rules, will result in a disqualification of the REIT. Although taxable REIT subsidiaries can be used to furnish the services that do not produce qualifying income but that are beneficial for the fund to provide, the use of such subsidiaries complicates the investment process and generates taxable income to the taxable REIT subsidiary, and the aggregate value of such subsidiaries may not exceed 20 percent of the aggregate value of the assets of the REIT.

In addition, the fund's investment and disposition strategy needs to take into account the rules under the Code relating to prohibited transactions. Section 857(b)(6) of the Code imposes a 100 percent tax on all gains from ''prohibited transactions'' which are defined as the disposition of property that is held primarily for sale to customers in the ordinary course of a trade or business. Because it can be difficult to determine whether a property is held primarily for sale, the Code, in Section 857(b)(6)(C), creates a safe harbor that excludes from the definition of ''prohibited transactions'' a sale of a property that has been held for at least four years for the production of rental income, provided that the total capital expenditures made by the REIT during the four—year period preceding the sale do not exceed 30 percent of the net sales price of the property.[14] To take advantage of this safe harbor in any taxable year, a REIT is not permitted to make more than seven such sales of property in such year.[15] Although it is not necessary to fall within the safe harbor, any particular disposition that does not fall within the safe harbor will need to be analyzed on a case by case basis to determine whether it will be characterized as a prohibited transaction.

### Free Transferability

The requirement that beneficial ownership interests in a REIT be evidenced by transferable shares may present a problem for sponsors, who are typically keenly interested in controlling the identity of the investors. Most funds prohibit investors from transferring their interests either by imposing an outright ban on transfers or by requiring investors to obtain the prior written consent of the general partner or managing member. Although institutional fund investors often do not rank liquidity as a priority and readily accept these restrictions, such limitations on transfers run directly counter to the free transferability required under the Code. The tension between the desire for transfer restrictions and the Code's transferability requirement is sometimes resolved by entering into a separate agreement giving the other investors, the fund or the general partner/managing member a right of first refusal with respect to the sale of interests in the REIT. However, although providing for such a right of first refusal gives a sponsor some comfort in its ability to control the identity of the investors, the first refusal right may not ultimately prove to be successful in achieving this objective. For example, if none of the other investors chooses to exercise its right of first refusal and the sponsor is unable, pursuant to the fund documents, to make a capital call or otherwise to obtain funding in order to be able to exercise its right of first refusal, the transfer to the third party may be consummated notwithstanding that the sponsor disapproves of the transferee. As discussed below, such a third—party transfer may also increase the risk that the REIT will become an investment company under the Investment Company Act. Other customary requirements associated with the transfer of interests in a fund—for example, that the transfer not violate securities laws and that the transferee assume the transferor's obligations under the fund's organizational documents—should not run afoul of the free transferability requirement.

### Ownership Tests

If existing investors exercise the right of first refusal, then the REIT runs the risk of violating the 100 Shareholder Test or the Closely Held Test by consolidating the ownership of shares into fewer hands. The risk of violating the 100 Shareholder Test can be mitigated by increasing the number of investors in the REIT to something more than 100, to allow a cushion for consolidation of shares. In order to further reduce the risk that a transfer will result in a violation of the 100 Shareholder Test or the Closely Held Test, the organizational documents of many REITs contain ''REIT—protective'' restrictions providing that any transfers (including transfers resulting from the exercise of the right of first refusal discussed below) that result in a violation of the 100 Shareholder Test or the Closely Held Test are to be treated as void ab initio, and that any shares transferred in violation of these restrictions are to be vested in a charitable trust rather than in the transferee. Such restrictions are not viewed as violating the requirement that shares of a REIT be transferable.

The need to satisfy the Closely Held Test and the 100 Shareholder Test may be problematic for a number of other reasons. In allocating fund interests, the sponsor must be careful not to grant too large an interest to any investor for fear of violating the Closely Held Test, and this may well reduce the aggregate commitments that the sponsor will be able to accept.[16] The sponsor will also need to contend with the logistical difficulties of forming and managing a fund with 100 or more investors, including the task of identifying 100 or more investors that satisfy the suitability requirements for a ''private placement'' under the Securities Act of 1933. In order to attract the requisite number of investors it may be expeditious to create a separate class of preferred interests with a high rate of return and a liquidation priority. Because such a class of preferred interests dilutes the return of the other investors in the fund (as well as the ''carried interest'' of the sponsor), the sponsor has an interest in minimizing the size of the preferred offering; indeed, even if common interests are offered, they will be sold more easily if they can be purchased in small denominations. However, setting too low a minimum investment for purposes of achieving the 100 shareholder threshold runs the risk that the smaller interests will be disregarded for purposes of the 100 Shareholder Test. The marketing of shares in the REIT to third parties in order to meet the 100 Shareholder Test may be supplemented by offering shares to employees of the sponsor and other persons associated with the sponsor of the fund; employee ownership can also be a method for preserving compliance with the 100 Shareholder Test in the event of consolidation of shares after the closing of the fund.

## Investment Company Act Compliance

Meeting the 100 Shareholder Test can increase the difficulty of avoiding characterization of the REIT as an investment company under the Investment Company Act. One of the exemptions from the Investment Company Act often relied on by funds is Section 3(c)(1) of the Investment Company Act, which creates an exemption from the Act's requirements for entities with 100 or fewer beneficial owners. Compliance with the 100 Shareholder Test—particularly if coupled with a cushion of additional shareholders to avoid future violation of the test—will inevitably complicate reliance on Section 3(c)(1). One possible solution to this problem lies in the fact there are certain investors who do not count toward the 100—person cap prescribed by Section 3(c)(1) but who nevertheless count as shareholders for purposes of the 100 Shareholder Test. Reg. § 270.3c—5 of the Investment Company Act provides that for purposes of determining the number of owners of an entity, certain high level officers of the entity, and employees of the entity, who participate in the investment activities of the entity for at least 12 months (''Knowledgeable Employees'') are excluded, along with any companies owned exclusively by Knowledgeable Employees. Accordingly, if the investors in the REIT include Knowledgeable Employees, it may be possible to fall within the Section 3(c)(1) exemption and also satisfy the 100 Shareholder Test.

It should be noted that transfers of shares in the REIT—which, as described above, cannot be too severely restricted lest the requirement of free transferability of shares be violated—could result in the fund falling outside the Section 3(c)(1) exemption if Knowledgeable Employees were to transfer their interests to investors who are not Knowledgeable Employees. The ease of walking this tightrope will depend in part on the number of investors in the REIT and the percentage of the investors who are Knowledgeable Employees—the closer the total number of investors to 100, and the larger the number of those investors who qualify as Knowledgeable Employees, the less risk there will be of exceeding the 100—investor limitation for purposes of Section 3(c)(1). Including provisions in the REIT's organizational documents making void ab initio any transfer by a Knowledgeable Employee to a person that is not a Knowledgeable Employee that would cause the REIT to be an investment company should help solve this problem.

If the REIT is unable to rely on the Section 3(c)(1) exemption, there are two other exemptions that real estate funds may rely on in order to avoid becoming an ''investment company'' under the Investment Company Act. Section 3(c)(7) of the Investment Company Act provides that an entity will be exempt from the Investment Company Act if its outstanding securities are owned exclusively by persons who are ''qualified purchasers.'' This exemption may be difficult to achieve because the ''qualified purchaser'' standard (which is a higher standard than the standard for an ''accredited investor'' under the Securities Act of 1933) requires that an investor be an individual who owns at least $5,000,000 in investments, an entity that is owned by two or more family members that own at least $5,000,000 in investments, or any individual or entity, acting on its own account or the accounts of other qualified purchasers, that owns and invests, in the aggregate and on a discretionary basis, not less than $25,000,000. It may be difficult for a sponsor to locate 100 investors which satisfy this test.

Another potential exemption available to real estate investment funds is Section 3(c)(5)(C) of the Investment Company Act, which excludes from the scope of the Investment Company Act entities that are not engaged in the business of issuing redeemable securities, face—amount certificates of the installment type or periodic payment plan certificates[17] and that are primarily engaged in purchasing or otherwise acquiring mortgages and other liens and interests in real estate. The 3(c)(5)(c) exemption may be a less desirable exemption to rely upon than Section 3(c)(1) or 3(c)(7) because certain investments that the fund may otherwise wish to make—for example, limited partnership interests in real estate joint ventures—may not qualify as interests in real estate under Section 3(c)(5) and therefore may be unavailable as investments for the fund. This ''real estate exemption'' is more likely to be available under the simple REIT structure and the REIT Subsidiary Structure than in the case of the REIT Parent Structure, where the REIT does not own direct interests in the fund assets (and may in fact be only a limited partner in the fund).

Finally, a fourth potential means of avoiding characterization as an investment company is to rely on Section 3(a)(1)(C) of the Investment Company Act, which provides that an entity will not be treated as an investment company if not more than 40 percent of its assets are ''investment securities'' under the Act. The direct ownership of real estate, or the ownership of 50 percent or more of the voting securities in an entity that directly owns real estate, will generally not be considered ownership of an investment security for this purpose, although mortgage and limited partnership interests may be considered investment securities.

## Conclusion

Various REIT structures have increasingly been used in the private equity industry to limit UBTI for tax—exempt investors. However, fund managers and investors and their advisors need to be cognizant of the effect that compliance with the Code, coupled with the overlay of the Investment Company Act, will have on the structuring, operation and management of a proposed fund. Assuming that meeting the applicable requirements of the Code and the Investment Company Act is consistent with the fund's business objectives and does not pose an insurmountable obstacle to forming and structuring the fund, the REIT can be a valuable device in resolving the UBTI issue.

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[1] Although other types of funds may also be leveraged, these funds often hold investments through corporate ''blockers.''

[2] The REIT structure has been used in the initial structuring of funds, but has also been used to ''retrofit'' existing funds without substantial UBTI protection.

[3] Code § 857(a)(1).

[4] References in this article to the ''REIT rules'' refer to §§ 856 to 859 of the Code and the regulations promulgated thereunder.

[5] ''Acquisition indebtedness'' includes the amount of any indebtedness incurred in acquiring or improving property, indebtedness incurred before the acquisition or improvement of the property if such indebtedness would not have been incurred but for the acquisition or improvement of the property and the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

[6] Note, however, that the use of a REIT to eliminate UBTI may not be successful in the case of REITs with significant pension fund ownership. If a pension fund holds more than 10 percent (by value) in any ''pension—held REIT'' (i.e., a REIT in which either a pension fund owns more than 25 percent (by value) of the interests in the REIT or one or more pension funds, each of which owns more than 10 percent by value of the interests in a REIT, hold in the aggregate more than 50 percent (by value) of the interests in the REIT) at any time during a taxable year, any UBTI that would have been ''cleansed'' as a result of the use of a REIT will nevertheless still constitute UBTI to the pension fund holding more than said 10 percent. Code § 856(h)(3)(C)—(E).

[7] ''Prohibited transactions'' are defined as dispositions of property held primarily for sale to customers in the ordinary course of a trade or business.

[8] Code § 856(c). Section 856(c)(4)(B) also imposes limitations on the percentage of a REIT's total assets that may be represented by securities.

[9] Code, § 856(a)(1) and (a)(3).

[10] Code, § 856(a)(2).

[11] Code § 856(a)(5) and § 856(b).

[12] Code § 856(a) and § 856(b).

[13] Although this discussion is focused on three principal REIT structures, it is important to note that there are many structural permutations that may be implemented.

[14] With respect to property acquired through foreclosure (or deed in lieu thereof) § 857(b)(6)(D) provides that the period of time during which the REIT held a loan secured by such property counts toward the holding period and that certain expenditures relating to foreclosure property do not count toward the cap on capital expenditures.

[15] Sales of multiple properties are treated as one sale, as long as they are negotiated as a single transaction.

[16] For the purposes of the Closely Held Test, certain tax—exempt investors, such as private foundations, are treated as single investors (Code § 542(a)(2)) whereas other tax—exempt investors, such as pension funds, are ''looked through,'' so that the beneficiaries of the pension fund are treated as separate investors in the fund itself. Code § 856(h)(3). In addition, university endowments and public charities are treated as an infinite number of investors.

[17] Redeemable securities, face—amount certificates of the installment type and periodic payment plan certificates generally refer to interests which entitle the holder to receive a payment on a specified date or dates or upon demand.