

REITs Demystified: An Introduction to Real Estate Investment Trusts

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The real estate investment market teems with an alphabet soup of options—Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC), Real Estate Mortgage Investment Conduits (REMIC), Real Estate Private Equity (PE) Funds, Master Limited Partnerships (MLP), and so on. Each option has a unique profile of economic, legal, and tax characteristics, and one's choice among the available options can have great consequence. This article provides a brief overview of common real estate investment vehicles and discusses some objectives REITs are suited to achieve and others they are not. The scope is limited to investment vehicles fit for passive investors, so vehicles that require investors' active participation, such as many partnerships and joint ventures, are not addressed.

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Overview of Investment Vehicles

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This section surveys five common real estate investment vehicles: (1) REITs, (2) REOCs, (3) REMICs, (4) real estate PE funds, and (5) MLPs. REITs, being the central focus, are covered in the greatest depth.

Real Estate Investment Trusts (REITs)

A REIT is a business entity that is taxable as a corporation for federal income tax purposes and makes a valid REIT election with the IRS. REITs can take various corporate forms, such as corporations, business trusts, or limited liability companies, but most REITs are formed as Maryland corporations.[1] REITs must comply with a complex set of tax rules and regulations to maintain their status, with requirements governing such matters as the sources of the REIT's income, what it does with that income, the types of assets it holds, and much more. A REIT generally must distribute (via dividends) at least 90% of its taxable income each year[2] and, unlike most C corporations, receives an income tax deduction for the dividends it pays,[3] thereby achieving modified pass-through status and avoiding double taxation. Certain types of income are excluded from "taxable income" for purposes of the 90% distribution requirement, including capital gains.

The pass-through status of a REIT is unlike that of other entities in several important respects. For example, unlike other pass-through entities, a REIT cannot pass losses through to its shareholders. Also, the dividends paid by a REIT are generally not eligible for the reduced tax rates for "qualifying dividend income," though under the Tax Cuts and Jobs Act (TCJA), certain REIT dividends qualify for a deduction of up to 20% for individual investors.[4] If a REIT retains any of its taxable income in excess of the 90% distribution requirement, the retained income is taxed at ordinary corporate rates. As such, most REITs seek to annually distribute 100% of their taxable income.

REITs are prohibited from acting as dealers in property, which means they may not sell inventory[5] to customers in the ordinary course of their business. Any transaction in violation of this prohibition is subject to a 100% tax on the net income realized. These rules help ensure that REITs remain true to their original

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purpose: serving as passive investors, like mutual funds for real estate, not property developers.

REITs are also subject to certain ownership restrictions. For example, there must be at least 100 shareholders,[6] and the REIT may not be "closely held," meaning the five largest individual[7] shareholders may not own more than 50% of the value of the REIT's stock.[8] The prohibition on being "closely held" is subject to look-through rules, which allow the REIT to look through most types of entities, including public charities, domestic pension plans, and profit-sharing plans, for purposes of the closely-held rules. The ownership restrictions imposed by the tax rules and regulations are reinforced by excess-share provisions in the charter documents of most REITs,[9] which prevent any investor from acquiring a large block of REIT stock.[10]

Investors typically contribute either cash or real estate in exchange for their interest in the REIT, and most REITs have a feature that allows investors to defer the income tax on their contributions of appreciated properties.[11] REITs often hold their investments through a limited partnership, commonly known as an "umbrella partnership," and the combined structure is known as an "umbrella partnership REIT"—or an UPREIT. The REIT serves as the general partner of the umbrella partnership, and investors may contribute real estate with built-in gain[12] to the umbrella partnership without triggering tax on the built-in gain. UPREIT investors do, however, incur income tax on their built-in gains when either (a) they exchange their limited partner interests for REIT shares, or (b) the umbrella partnership eventually sells the contributed real estate.[13]

REIT status offers unique benefits for tax-exempt investors that are subject to unrelated business taxable income (UBTI).[14] Such tax-exempt investors generally can use REITs to invest in leveraged real estate without incurring tax on UBTI, though REITs owned largely by pension plan investors are subject to special rules that can cause those investors to recognize UBTI.

REITs allow foreign investors to indirectly invest in U.S. real estate without incurring Foreign Investment in Real Property Tax Act (FIRPTA) tax on the gain from their sale of REIT stock, so long as the REIT is "domestically controlled," meaning less than 50% of the

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value of its stock is held directly or indirectly by foreign investors. Some types of foreign investors, such as sovereign wealth funds and qualified foreign pension funds, may benefit from REIT structures even if the REIT is not domestically controlled.

Most REITs are publicly-traded,[15] but some are privately held, and yet others register the offering of their stock with the U.S. Securities and Exchange Commission (SEC) under the Securities Act of 1933 but do not list their stock on any national securities exchange (often referred to as public non-traded REITs).[16] Publicly-traded REITs offer significant liquidity, as their shares can be readily traded on national securities exchanges. Privately-held and public non-traded REITs typically offer liquidity by allowing investors to sell their shares back to the REIT, commonly known as redemption rights, but such rights are usually subject to the REIT directors' discretion and the availability of sufficient cash.

REITs are required to hold primarily real estate assets and to generate most of their income passively from those assets. REITs typically own:

(a) direct or indirect equity interests in real estate (equity REITs);

(b) debt secured by real estate (mortgage REITs); or

(c) some combination of equity and debt interests (hybrid REITs).

Many REITs focus on equity or debt interests in a certain sector of the economy, such as health care, hospitality, timberland, or data centers.

Real Estate Operating Companies (REOCs)

REOCs are similar to REITs in some respects; they invest in real estate, they often focus on one or more sectors, and they are predominantly publicly-traded. REOCs are not, however, subject to the complex rules and restrictions that apply to REITs, including the 90% distribution requirement. So, unlike a REIT, a REOC may retain an unlimited amount of its net income for reinvestment in the business, such as financing new acquisitions or capital improvements to existing properties. But the greater flexibility enjoyed by REOCs comes at a price—unlike REITs, publicly-traded

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REOCs are not pass-through entities, so they are subject to double taxation. The tax and economic characteristics of REOCs are generally suited for growth-oriented investment strategies, while REITs are primarily yield-oriented.[17]

Real Estate Mortgage Investment Conduits

A REMIC pools mortgage loans and issues mortgage-backed securities. Any type of business entity or trust can qualify as a REMIC, so long as it satisfies the statutory criteria and makes a valid REMIC election—though in practice, REMICs are typically formed as trusts. A REMIC is a pass-through entity, so income is taxed only at the investor level. Unlike mortgage REITs, REMIC interests typically are not publicly-traded.[18]

Substantially all the assets of a REMIC must consist of mortgages secured by interests in real estate.[19] The mortgages generally must be transferred to the REMIC on the date it is formed or, under some circumstances, be acquired by the REMIC within three months of formation. Because REMICs must be fully funded not long after formation, they are largely inactive after funding. While REMICs resemble mortgage REITs in some respects, unlike REMICs, mortgage REITs may be actively managed and grow for an unlimited period.

REMICs may only have two types of ownership interests—regular interests and residual interests. Regular interests are similar to debt instruments in that they generally entitle their holders to payments of principal and interest, though some pay only principal and others only interest.[20] There are typically multiple classes of regular interests, known as tranches, with different maturities, coupons, payment priorities, risk profiles, and other features.

Residual interests, on the other hand, are like equity interests. Residual interest holders generally do not receive any payments until the regular interests have been fully satisfied, and they typically receive any assets remaining after the liquidation and termination of the REMIC. All residual interests must be of a single class and must pay distributions pro rata.

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REMICs must comply with complex legal requirements to maintain their tax status. The requirements are largely meant to ensure that REMICs serve as a conduit for investing in mortgages and for no other purpose.

Real Estate Private Equity Funds

Real estate PE funds pool equity for investment in real estate deals, and they often focus on a particular property type, such as commercial or multi-family. The funds are created by sponsors who raise equity capital from passive investors and manage the enterprise. Real estate PE funds are often formed as limited partnerships, or limited liability companies structured like limited partnerships, and the sponsor is referred to as a general partner (GP), while the investors are referred to as limited partners (LPs). The GP uses the equity invested by the LPs along with debt capital to finance the acquisition or development of one or more real estate projects. Real estate PE funds are pass-through entities for income tax purposes.

There are generally five principal investment strategies employed by real estate PE funds, listed in order from lowest risk/return to highest:

(1) Core;

(2) Core-plus;

(3) Value-add;

(4) Opportunity; and

(5) Distressed or mezzanine debt.[21]

Strategies on the low end of the risk/reward spectrum generally have low or no leverage and tend to focus on well-occupied, stable, high-quality assets in primary or secondary markets. Investor returns on the low end of the spectrum predominantly consist of income yield rather than appreciation. Strategies on the high end of the spectrum tend to have moderate to high leverage and typically focus on assets in need of improvement or in distress. The higher up the spectrum, the more returns consist of appreciation rather than yield.[22]

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The economic structure of a real estate PE fund is designed to provide an attractive return to LPs while rewarding the GP for its work and the heightened risk it assumes.[23] The LPs typically provide the vast majority of the equity capital, and the GP makes a relatively small capital contribution. The LPs usually receive a priority return of capital and a preferred return.[24] After the preferred return has been satisfied, the GP receives a percentage of profits significantly greater than its ownership percentage, typically ranging from about 15% to 20%. The GP's profits interest is commonly called a "promoted interest," a "promote," or a "carried interest." In addition to the promoted interest, the GP usually receives fees for a variety of services such as fundraising, managing acquisitions, asset management, and property management.

As the name indicates, LP interests in real estate PE funds are privately held and not publicly traded, so the interests may be sold only to certain investors and are subject to legal and contractual transfer restrictions. The general lack of a secondary market means that interests in real estate PE funds are highly illiquid, especially compared to publicly-traded vehicles like many REITs and REOCs.

Master Limited Partnerships (MLPs)

MLPs are limited partnerships that, unlike most partnerships, issue publicly-traded equity interests, typically called "units." MLPs were widely used as real estate investment vehicles during the 1980s and 1990s, but their use in the real estate space has greatly declined since. As of 2017, only about 3% of MLPs focused on real estate, and today they are used predominantly for investment in energy-related industries, especially midstream activities such as the transportation, processing, and storage of oil and natural gas.[25]

Like real estate PE funds, MLPs are managed by a GP, and the investors are referred to as "limited partners" or "unitholders." The GP's compensation often includes "incentive distribution rights," which are similar in some respects to the promoted interest held by the GP of a real estate PE fund.[26] Like REITs, unitholders generally invest in MLPs primarily for stable income yield rather than appreciation.[27]

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MLPs are pass-through entities that are taxed as partnerships for income tax purposes. In order to maintain their pass-through status, however, at least 90% of their income must be limited to a narrow set of categories, including real estate rents, gain from the sale of real estate, and income and capital gains from various energy- and natural resources-related activities.

MLPs have several drawbacks compared to REITs, which likely contributed to their steep decline in the real estate space. For example, unlike REITs, MLPs can generate UBTI for tax-exempt investors. MLPs do not offer foreign investors the benefits provided by REITs. And, because MLPs are taxed as partnerships, the accounting burden is much greater for an MLP than a REIT.[28] For instance, each partner in an MLP may have a different tax basis in his or her share of the partnership property, so separate records must be maintained for each partner. Likewise, income tax preparation is generally more burdensome for limited partners of an MLP than for shareholders of a REIT.[29]

Objectives Suited for REITs

The legal, tax, and economic characteristics of REITs make them uniquely suited to achieve certain business and investment objectives. For instance, if you want to form a vehicle for investment in real estate equity that is publicly-traded and avoids double taxation, a REIT is the clear favorite. As discussed above, MLPs could in theory serve this purpose, but they have several disadvantages compared to REITs, which perhaps explains why the use of MLPs in the real estate space has precipitously declined for decades.[30]

REITs lend themselves to certain asset classes and investment strategies. Given their inability to reinvest most of their earnings, REITs generally employ lower-risk strategies, such as core and core-plus, which focus on high-quality, stabilized properties with strong cash flow.[31]

Sponsors looking to create an evergreen vehicle for mortgage investments are better served by a mortgage REIT than a REMIC. While REMICs are generally closed off from acquiring new mortgages after three months from formation, mortgage REITs can

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acquire new assets and grow indefinitely.

REITs are primarily yield-oriented investment vehicles, thanks largely to the 90% distribution requirement, though they generally offer greater opportunity for long-term capital appreciation than some other yield-oriented investments like bonds.[32] REITs can also serve as a hedge against inflation, especially those focused on commercial properties, because rents under commercial leases often adjust upward with inflation.[33]

Certain types of investors may find REITs especially appealing. As discussed above, they offer tax-exempt investors a way to invest in leveraged real estate without recognizing UBTI, though this feature is little benefit to super-tax-exempt investors like state pension funds. REITs offer foreign investors a way to tax-efficiently invest in U.S. real estate. The UPREIT structure allows owners of appreciated real estate to diversify their holdings and access liquidity, all on a tax-deferred basis. Also, because of the simplified income tax reporting that comes with corporate status, REITs may appeal to certain individual investors who might not have the bandwidth or desire to handle the complex Schedule K-1s or the tax preparation burden that comes with most pass-through real estate investment vehicles.

An article recently published in the "Yale Law Journal" offers a new and interesting theory to explain the growth and popularity of REITs.[34] The theory centers on a fundamental income tax problem inherent in real estate investment: partners who contribute property with built-in gain[35] to a partnership have all the tax attributable to that built-in gain allocated to them when the partnership eventually sells the property. So, when a partnership sells a property with built-in gain, the partner who contributed that property participates in the profit from the sale pro rata while shouldering a disproportionate share of the income tax burden. This puts the interests of cash investors and property contributors at odds. According to the authors, REITs enable sponsors to effectively mediate these conflicting interests because the sponsor is largely insulated from investor pressure. Thanks to the prohibition on being "closely held" and the excess-share provisions in their charter documents, REITs are highly resistant to hostile takeovers, thereby

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sheltering the directors from the threat of activist investors who might try to pressure them to aggressively liquidate assets at the expense of property contributors.[36] Yet, hostile takeovers are important implements of modern corporate governance and accountability. The authors theorize that the requirement to distribute at least 90% of taxable income serves as a substitute for the possibility of a hostile takeover. In essence, REIT directors are given the insulation and independence to mediate conflicting investor interests, but they are held in check by their general inability to divert corporate earnings for self-serving purposes.

Objectives Better Suited for Other Vehicles

Every rose has its thorn, of course, and so it is with REITs. Some business and investment objectives are better left to other vehicles. For example, because REITs generally must distribute at least 90% of their taxable income, they are not appropriate for investment strategies that rely heavily on the reinvestment of earnings. Likewise, due to the 100% tax on sales of inventory, REITs are generally not suited for strategies involving the development or improvement of property with an eye toward resale. As such, sponsors engaged in property development and those who pursue value-add and opportunity strategies are generally a better fit for REOCs and real estate PE funds.

The pass-through status enjoyed by REITs is different from that of other vehicles, and the differences present certain limitations. For example, unlike most other pass-through entities, REITs may not pass through losses to investors. So investment strategies that involve generating deductible losses for investors are better suited for other pass-through vehicles like real estate PE funds.

A sponsor looking for the flexibility to invest in both real estate and non-real estate assets is generally not a good fit for a REIT, though, depending on the circumstances, a taxable REIT subsidiary (TRS) may fit the bill. A TRS is a subsidiary of a REIT that is taxable as a C corporation and is permitted to engage in certain activities prohibited for REITs. Otherwise, a REOC might work if double taxation is acceptable, and if not, an MLP may serve depending on the non-real estate assets involved.

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REITs are complex, and with complexity comes cost. A sponsor planning to form a REIT must be prepared for the significant legal, tax, administrative, compliance, and other costs and burdens involved, which, if the REIT is to be publicly-traded, include the costs of going public.

Sponsors that prioritize the minimization of such costs may want to consider other vehicles.

Contact Scott J. Bent to discuss your investment goals and what real estate investment vehicles are a good fit.

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[1] A Theory of the REIT, by Jason S. Oh and Andrew Verstein. 133 Yale L.J. 755 (2024).

[2] I.R.C. § 857(a)(1).

[3] I.R.C. §§ 561, 857.

[4] Without further legislation, the TCJA deduction will sunset after 2025.

[5] In this context, the term "inventory" means property owned or developed for the primary purpose of resale, as opposed to property held for a long term for the primary purpose of generating cash flow.

[6] I.R.C. § 856(a)(5).

[7] The term "individual" for this purpose includes natural persons, private foundations, supplemental unemployment compensation plans, and charitable remainder trusts.

[8] I.R.C. § 542(a)(2), 856(a)(6), and 856(h)(1)(A).

[9] Oh and Verstein, 133 Yale L.J. at 769.

[10] Excess-share provisions often allow a REIT shareholder to exceed the applicable ownership percentage limitation if the shareholder obtains a waiver from the REIT's board of directors.

[11] Oh and Verstein, 133 Yale L.J. at, 787-788.

[12] The term "built-in gain" as used here refers to the unrealized gain in a property at the time it is contributed to an umbrella partnership. For example, if an investor has a $10 income tax basis

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in a property, and the value of that property is $100 when the investor contributes it to an umbrella partnership, the built-in gain is $90.

[13] As discussed in the section titled "Objectives Suited for REITs," the entire built-in gain that existed at the time of the contribution is generally allocated to the contributing partner when the umbrella partnership sells the contributed property, which places the interests of cash investors and property contributors at odds.

[14] UBTI is generally income earned by a tax-exempt entity that is not related to the entity's tax-exempt purpose (including, importantly, income from debt-financed real estate). UBTI is subject to income taxation. Some tax-exempt entities are not subject to UBTI, and they are commonly referred to as "super-tax-exempt." Examples of super-tax-exempt entities include integral parts of states and localities, as well as pensions for government employees.

[15] Oh and Verstein, 133 Yale L.J. at 812.

[16] Public non-traded REITs allow sponsors to raise capital from the general public without limitation as to the net worth or sophistication of the investor. Private REITs, on the other hand, are generally allowed to raise capital only from "accredited investors."

[17] Real Estate Operating Company (REOC) – Overview, How It Operates, Corporate Finance Institute: https://corporatefinanceinstitute.com/resources/commercial-real-estate/real-estate-operating-company-reoc/; Investing in Real Estate Investment Trusts (REITs), Charles Schwab: https://www.schwab.com/stocks/understand-stocks/reits; What's Right with REITs, Fidelity: https://www.fidelity.com/learning-center/trading-investing/investing-in-REITs; Guide to Equity REIT Investing, NAREIT: https://www.reit.com/what-reit/types-reits/guide-equity-reits; Real Estate Investment Trusts: Alternatives to Ownership, FINRA: https://www.finra.org/investors/insights/reits-alternatives-to-ownership.

[18] The CPA Journal, Tax Aspects of Investing in REITs and REMICs, Elizabeth Gurvits: https://www.cpajournal.com/2016/10/01/tax-aspects-of-investing-in-reits-and-remics/.

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[19] I.R.C. § 860D(a)(4) and 860G(a)(3).

[20] Regular interests are also treated like debt instruments for income tax purposes.

[21] Creating a Private Equity Fund: A Guide for Real Estate Professionals, Jan A. deRoos and Shaun Bond: researchreportnaiop-creating-a-private-equity-fund-white-paper.pdf.

[22] *Id.*

[23] The risks assumed by the GP often include guaranties of indebtedness used to acquire or develop assets.

[24] A "preferred return" is the minimum return that LPs must receive before the GP can participate in the profits of the fund. It is often called a "hurdle rate."

[25] Master Limited Partnerships 101: Understanding MLPs, Master Limited Partnership Association: https://www.mlpassociation.org/wp-content/uploads/2015/08/MLP-101-MLPA.pdf.

[26] *Id.*

[27] *Id.*

[28] Real Estate Investment Trusts, by Micah Bloomfield, Evan Hudson, and Mitchell Snow. Chapter 1, Section 1:76.

[29] Limited partners in an MLP receive annual Form K-1s, which are generally more complicated than the Form 1099s received by REIT shareholders. The Form K-1 can be especially complicated and burdensome if the MLP owns real estate located in various states.

[30] Master Limited Partnerships 101: Understanding MLPs, Master Limited Partnership Association: https://www.mlpassociation.org/wp-content/uploads/2015/08/MLP-101-MLPA.pdf.

[31] Alternative Investments: The Case for Real Estate, Franklin Templeton: https://www.franklintempleton.com/articles/blogs/alternative-investments-the-case-for-real-estate; The Definitive Breakdown of REITs vs Private REITs, Aspen Funds:

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https://aspenfunds.us/breakdown-reits-private-reits/.

[32] What are REITs and How to Invest in Them, "U.S. News & World Report": https://money.usnews.com/investing/real-estate-investments/articles/the-ultimate-guide-to-reits; Guide to Equity REIT Investing, NAREIT: https://www.reit.com/what-reit/types-reits/guide-equity-reits; REITs vs. Bonds: Which are the Better Investment?, First National Realty Partners: https://fnrpusa.com

[33] How REITs Provide Protection Against Inflation, NAREIT, Nicole Funari: https://www.reit.com/news/blog/market-commentary/how-reits-provide-protection-against-inflation.

[34] A Theory of the REIT, by Jason S. Oh and Andrew Verstein, 133 Yale L.J. 755, 768 (2024).

[35] As explained in endnote 13, the term "built-in gain" as used here refers to the unrealized gain in a property at the time it is contributed to a partnership.

[36] Shareholder activism in the REIT space has increased over the last decade. There have been very few hostile takeovers, but it is not unusual to see a transaction such as a merger or a spin off not long after an activist shareholder acquires a position in a REIT. See, e.g., Activists Seek REIT Renovations, Ronald Orol: https://www.thedeal.com/activism/activists-seek-reit-renovations; Activists Are Now Knocking on the Doors of REITs, Moira Conlon: https://www.linkedin.com/pulse/activists-now-knocking-doors-reits-moira-conlon-1/.

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