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Bradley T. Borden
bradley.borden@brooklaw.edu

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RETHINKING THE TAX-REVENUE EFFECT OF REIT TAXATION

*Bradley T. Borden**

ABSTRACT

Real estate investment trusts (REITs) have recently made headlines in major media outlets and have caught the attention of lawmakers and analysts because they erode the corporate tax base. REITs are not subject to the entity-level tax that typically applies to corporations. To avoid being taxed on real estate income, some corporations spin off real estate into REITs. After a REIT spinoff, such corporations rent the real estate from the REIT and continue to use it in their operations. Thus, a mere change in corporate form removes taxable income from the corporation (i.e., erodes the corporate tax base) and eliminates the entity-level tax on income from the spun-off real estate. This erosion of the corporate tax base concerns lawmakers (who have proposed prohibiting tax-free REIT spinoffs), some economists, and the media. Another concern is that the IRS has extended REIT classification to entities that hold nontraditional real estate, such as telecommunications infrastructure, billboards, oil and gas pipeline systems, timber, casinos, prisons, and data centers. The extension of REIT taxation to nontraditional real estate may not erode the corporate tax base because the assets may come from noncorporate entities. Thus, the tax-revenue effect of REIT taxation extends beyond REIT spinoffs and the erosion of the corporate tax base. Nonetheless, intuition suggests that more REIT spinoffs, the expansion of REIT taxation, and the growth of the REIT industry must erode the corporate tax base and significantly reduce government tax

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revenue. This Article challenges that intuition and presents two counterintuitive findings. First, it shows that REIT spinoffs can actually increase tax revenue even though they erode the corporate tax base. Second, it reveals that loss of tax revenue from REIT taxation primarily results from REITs forming from partnerships, not from REIT spinoffs. The Article concludes by recommending how these findings should influence discussions of REIT reform.

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I. INTRODUCTION

A recent article in *The New York Times* opens with the claim, "Rage is rising over American corporations that chop their tax bills . . . ."[1] The article leads by discussing the fury caused by corporate inversions, but it focuses on the announced spinoff of Windstream Corporation's copper and fiber network into a real estate investment trust (REIT).[2] REIT spinoffs and their cousin transaction, REIT conversions, have also caught the attention of lawmakers, as House Ways and Means Committee Chair Dave Camp has proposed

1. *See* Gretchen Morgenson, *A Corporate Tax Break That's Closer to Home*, N.Y. TIMES, Aug. 10, 2014, at BU1 [hereinafter Morgenson, *Closer to Home*].
2. *See id.*

legislation that would end favorable tax treatment for such transactions.[3] A vocal tax economist has also joined the chorus, expressing concern about the loss of corporate tax revenue and trying to build opposition to REIT spinoffs and conversions.[4] Consequently, REITs appear to be in the crosshairs of the media, lawmakers, and analysts. Nonetheless, REITs have largely escaped the critical attention of policy and tax-law scholars. This Article addresses that oversight and argues that the legislative, analytical, and media reaction to REIT spinoffs is misguided.

The comparison of REIT spinoffs to corporate inversions borders on misplaced hysteria. Stated very simply, a corporate inversion is a change of corporate headquarters from a U.S. location to a non-U.S. location that has a relatively low corporate tax rate and favorable treaty relations with the United States.[5] The inversion arguably has little effect on the overall operations and control of the inverting corporation, but it moves future corporate income offshore, excluding it from the U.S. corporate-tax base.[6] A formalistic change in organization that results in taxable income leaving the United States is troubling. The media would like to group REIT spinoffs and corporate inversions into the same category,[7] but REIT spinoffs are not as pernicious as

3. *See* 113TH CONG, TAX REFORM ACT OF 2014, (Discussion Draft), § 3631 (Feb. 21, 2014) (proposing prohibiting tax-free spinoffs to REITs and preventing a corporation from making a REIT election if the corporation was part of a tax-free spinoff within the ten years preceding the date of election); *id.* at § 3647 (proposing denying tax-free corporate conversions to REITs). The Tax Reform Act of 2014 includes other provisions that relate to REITs. *See id.* at §§ 3631–49. Other commentators have focused on many of the other provisions. *See, e.g.*, Willard B. Taylor, *More Comments on Camp's REIT Proposals*, 143 TAX NOTES 243 (Apr. 14, 2014). This Article focuses primarily on REIT spinoffs and conversions.

4. *See* Martin A. Sullivan, *Economic Analysis: The Economic Inefficiency of REIT Conversions*, 144 TAX NOTES 1229 (Sep. 15, 2014) [hereinafter Sullivan, *Economic Inefficiency*]; Martin A. Sullivan, *REIT Conversions: Good for Wall Street. Not Good for America*, THE TAX ANALYST BLOG (Sep. 15, 2014), http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/MSUN9NXQLG?OpenDocument; Martin A. Sullivan, *How Much Do Converted and Nontraditional REITs Cost the U.S. Treasury?* THE TAX ANALYSTS BLOG (Sep. 8, 2014), http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/MSUN9NRFWQ?Open Document. The analysis below shows that Sullivan's estimates of the tax-revenue effect of REITs is grossly overstated. *See infra* Part IV.B.4.

5. *See* KIMBERLY CLAUSING, URBAN-BROOKINGS TAX POLICY CENTER, CORPORATE INVERSIONS, (2014), http://www.urban.org/UploadedPDF/413207-corporate-inversions.pdf.

6. *See* Edward D. Kleinbard, *"Competitiveness" Has Nothing to Do With It*, 144 TAX NOTES 1055, 1065–67 (Sep. 1, 2014).

7. *See, e.g.*, Morgenson, *Closer to Home*, *supra* note 1; Howard Gleckman, *How REIT Spinoffs Will Further Erode the Corporate Tax Base*, FORBES (July 31, 2014), http://www.forbes.com/sites/beltway/2014/07/31/how-reit-spinoffs-

corporate inversions. A REIT spinoff does move taxable income from a corporation to a REIT, so that income can escape corporate taxation, but the income of a REIT generally is taxable to its shareholders.[8] This Article shows that variables other than corporate-tax-base erosion, such as the tax treatment of REIT shareholders, more profoundly influence the tax-revenue-effect of REIT spinoffs.[9]

REITs have also been portrayed negatively in the popular press over the last several years as more real property (including the Empire State Building and nontraditional real estate) migrates into REITs from noncorporate sources.[10] In fact, this Article shows that the growth of REITs

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will-further-erode-the-corporate-tax-base/ (identifying REITs as "an unmistakable opportunity" to minimize taxes); Thomas Gryta & Ryan Knutson, *Windstream Cleared to Cut Taxes by Forming a REIT: IRS Allows Firm to Classify Its Phone Lines as Real Estate*, WALL ST. J. (July 30, 2014), http://webreprints.djreprints.com/3438910250151.html (claiming, in part reference to the corporate-tax-base erosion that occurs as a result of REIT spinoffs, that the expanding REIT universe is a prime example of what's what is so bad about our tax code: special rules that favor certain taxpayers over others). Other reporters also covered the spinoff. *See, e.g.*, Cecile Daurant & Caitlin McCabe, *Windstream to Spin Off Networks Into Publicly Traded REIT*, BLOOMBERG NEWS (July 29, 2014), http://www.bloomberg.com/news/2014-07-29/windstream-to-spin-off-telecom-assets-into-publicly-traded-reit.html.

8. *See infra* text accompanying notes 41–42 (discussing the tax treatment of REIT income).

9. *See infra* Parts III.B–C.

10. *See* Brian Louis, *Paramount Said to Plan Biggest REIT IPO at $2.5 Billion*, BLOOMBERG NEWS (Aug. 28, 2014), http://www.bloomberg.com/news/2014-08-27/paramount-group-files-for-ipo-of-u-s-officelandlord.html; David M. Levitt, *Empire State Realty Trust Gains $929.5 Million IPO*, BLOOMBERG BUSINESSWEEK (Oct. 2, 2013), http://www.bloomberg.com/news/articles/2013-10-02/empire-state-realty-trust-gains-after-929-5-million-ipo [hereinafter Levitt, *IPO*]; James Glanz, *Landlords Double as Energy Brokers*, N.Y. TIMES (May 13, 2013), at B1, http://www.nytimes.com/2013/05/14/technology/north-jersey-data-center-industry-blurs-utility-real-estate-boundaries.html?pagewanted=all (reporting on the Equinix Inc. conversion and estimating that it would save the corporation more than $100 million in taxes); Brad Thomas, *Empire State Realty Trust: This Proposed New REIT Makes Cents*, FORBES (Feb. 15, 2013), http://www.forbes.com/sites/bradthomas/2013/02/15/empire-state-realty-trust-this-proposed-new-reit-makes-cents/2/ [hereinafter Thomas, *Makes Cents*]; Aaron Levitt, *Why Weird REITs Are Wonderful for Investors*, INVESTOR PLACE (Feb. 8, 2013), http://investorplace.com/2013/02/why-weird-reits-are-wonderful-forinvestors/#.VCNBmk1OxbU (identifying cold storage warehouses, cell phone towers, and salt caverns as types of property owned by some specialty REITs); Anton Troianovski, *Here's a Way to Cut Business Taxes: Tech Firms Become Real Estate Trusts*, WALL ST. J. (Oct. 11, 2012), http://www.wsj.com/articles/SB10000872396390444657804578048880778578720?autologin=y (estimating that American Tower Corp., a cellphone tower operator, would save $400 million a year in tax savings by 2017 and Equinix Inc., a datacenter, and Iron Mountain Inc., a

through non-spinoff mechanisms has a greater negative effect on tax revenue than REIT spinoffs do.[11]

Stated simply, REITs are tax corporations that qualify for favorable tax treatment.[12] Tax law requires corporations to compute taxable income and pay income tax (an entity-level tax),[13] and it generally requires shareholders to pay tax on dividends from corporations (a shareholder-lever tax).[14] Therefore distributed corporate income is subject to a double tax. Without a special rule from Congress, REITs would have to pay an entity-level tax, as all other corporations do. Instead, Congress provides that if REITs distribute at least 90 percent of their taxable income, they do not have to pay an entity-level tax on the distributed income.[15] REIT shareholders generally must pay tax on

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document shredder and datacenter, would save about $150 million of taxes by converting to REITs); Alison Gregor, *Specialty REITs, Exploiting Niche Categories, Outperform the Mainstream Players*, N.Y. TIMES (Dec. 21, 2011), at B6, http://www.nytimes.com/2011/12/21/realestate/commercial/specialty-real-estate-investment-trusts-excel-beyond-the-usual.html?pagewanted=all (identifying timber, self-storage properties, and data centers as types of property owned by some specialty REITs).

11. *See infra* Part IV.C.

12. A REIT must be an entity that, but for the REIT rules, would be subject to corporate tax as a domestic corporation. *See* I.R.C. § 856(a)(3). Such entities include state-law corporations, but they can also include electing state-law trusts, state-law partnerships, and limited liability companies. *See* Reg. §§ 301.7701–1 to –3.

13. *See* I.R.C. § 11(a).

14. *See* I.R.C. § 61(a)(7); *infra* text accompanying notes 39–40 (analyzing the tax treatment of corporate income and recognizing that dividends paid to some shareholders may be exempt from income tax). S corporations, which are not subject to corporate tax, are an exception to the general rule. *See* I.R.C. § 1363(a). Instead, an S corporation's taxable income passes through to its shareholders who report and pay tax on their respective pro rata shares of that income. *See* I.R.C. § 1366(a). As a general rule, S corporations can have no more than 100 individual shareholders. *See* I.R.C. § 1361(b). Consequently, S corporations are not publicly traded and do not factor into the choice of entity discussions in this Article.

15. *See* I.R.C. § 857(a)(1)(A) (requiring REITs to distribute at least 90 percent of their taxable income to avoid the entity-level tax); I.R.C. § 857(b) (2012) (allowing a deduction for dividends paid by a REIT to its shareholders). REITs also must satisfy an organizational test, an asset test, and an income test, which generally are not relevant to the analysis of the tax-revenue effect of REIT taxation. *See* §§ I.R.C. 856(c)(2)–(4). Nonetheless, those tests often receive at least overview attention in publications about REITs. *See, e.g.*, Bradley T. Borden, *Reforming REIT Taxation (or Not)*, 53 HOUS. L. REV. (forthcoming 2015) (on file with author) [hereinafter Borden, *Reforming REIT Taxation*]; JACK H. MCCALL, TENN. J. BUS. L., A PRIMER ON REAL ESTATE TRUSTS: THE LEGAL BASICS OF REITS 4–5 (Spring 2001) [hereinafter MCCALL, LEGAL BASICS].

dividends they receive from REITs,[16] but the absence of the entity-level tax generally makes REIT taxation appear to be more favorable than corporate double taxation.[17] This Article shows, however, that the nuances of our tax system and the complexity of investor taxation can undermine that general perception.[18]

REITs are part of the mainstream economy.[19] REITs come in three varieties: (1) equity REITs (own tangible real estate), (2) mortgage REITs (lend money to other real estate owners or operators or hold pools of mortgages or mortgage-backed securities), and (3) hybrid REITs (own real estate and mortgages).[20] The comparative market size of each type of REIT has fluctuated over time, but equity REITs have gained prominence over the last three decades.[21] Despite fluctuations and market cycles, the growth of REITs has been significant, especially over the last twenty years (see Figure 1[22]). Undoubtedly, much of that growth is attributable to REIT legislation and favorable regulation that expand the application of REIT taxation,[23] so the growth calls for greater academic attention to REITs.

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16. *See infra* text accompanying notes 41–42 (analyzing the tax treatment of REIT income and recognizing that dividends paid to tax-exempt entities may not be subject to income tax).

17. *See infra* text accompanying notes 39–49 (comparing the tax consequences of holding property in either a corporation or a REIT).

18. *See infra* Part III.B.1.

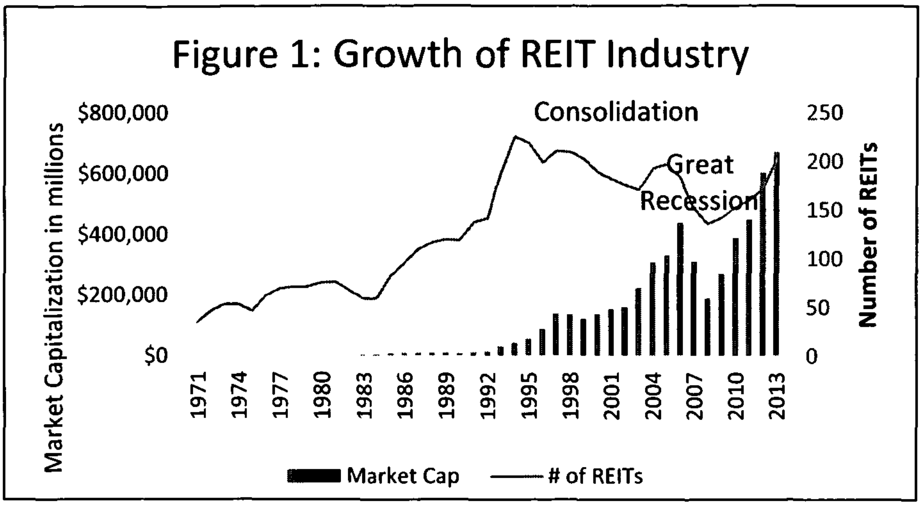
19. *See, e.g.*, Andrew McIntyre, *Cos. Looked to REIT Spinoffs to Unlock RE Value in 2014*, LAW 360 (Dec. 19, 2014) http://www.law360.com/articles/600704/cos-looked-to-reit-spinoffs-to-unlock-re-value-in-2014 (reporting major REIT activity in 2014).

20. *See* Robert J. Staffaroni, *Foreign Investors in RICs and REITs*, 56 TAX LAW. 511, 536 (2003) [hereinafter Staffaroni, *Foreign Investors*]; Joel Simpson Marcus, *An Analysis of Qualified Income Interest Problems of Mortgage REITs*, 37 J. TAX'N 348, 348–49 (Dec. 1972).

21. *See* Appendix A. At the time of the writing of this Article, there were no publicly-traded hybrid REITs. *See id.*

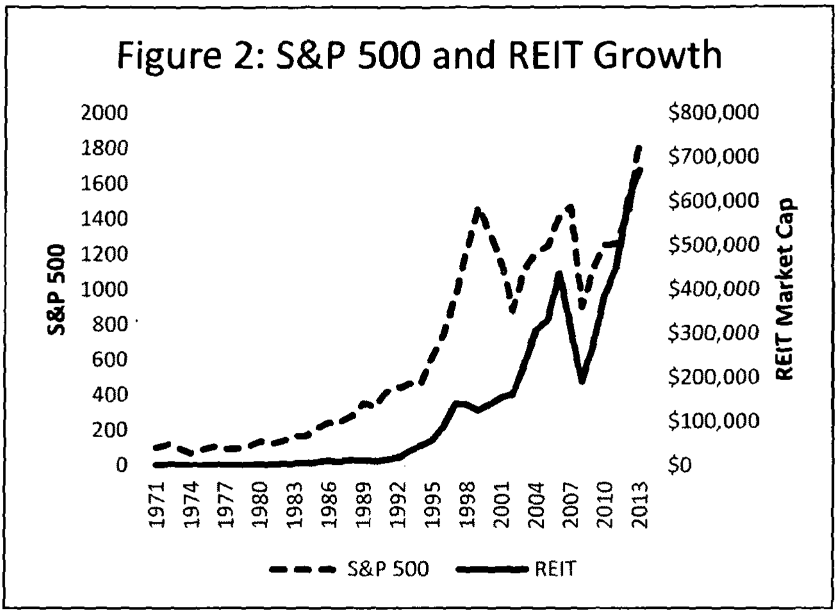
22. The data used to construct the chart in Figure 1 is from REIT.com, *U.S. REIT Industry Equity Market Cap--Historical REIT Industry Market Capitalization: 1972-2013*, http://www.reit.com/investing/industry-data-research/us-reit-industry-equity-market-cap. *See also* Appendix A.

23. Commentators have noted an apparent relationship between changes in REIT law and the growth of the REIT industry. *See, e.g.*, SU HAN CHAN ET AL., REAL ESTATE INVESTMENT TRUSTS: STRUCTURE, PERFORMANCE, AND INVESTMENT OPPORTUNITIES, 179 (2003) (recognizing that an "explosion in REIT security offerings" allowing greater institutional investment in REITs via legislative changes under I.R.C. § 856(h)(3) and The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13149(a), 107 Stat. 312, 445); Borden, *Reforming REIT Taxation*, *supra* note 15.



The growth of the REIT industry appears equally impressive when compared to other measures of general economic performance (*see* Figure 2). For instance, the S&P 500 index grew from 102 points at the end of 1971 to 1,846 points at the end of 2013.[24] That impressive 1,708 percent increase is dwarfed by the 44,759 percent increase of REIT market capitalization ($1,494,000,000 in 1971 to $670,334,000,000 in 2013) over the same period. The cause of the exceptional growth of REIT market capitalization appears to be at least somewhat attributable to the growth in the number of publicly traded REITs, but part of the growth appears to derive from the REITs increasing in value. Figure 2 also suggests that more recently, REITs and stock performance appear to track more closely. Over the last twenty years, the cycles of publicly traded REITs appear to have correlated with corporations, with the exception of general stock price reaction to the dot-com bubble in the late 1990s.

24. *See S&P 500 (^GSPC) Historical Prices*, YAHOO! FINANCE, https://finance.yahoo.com/q/hp?s=%5EGSPC&a=00&b=3&c=1971&d=10&e=1&f=2014&g=m&z=66&y=0.



The Author's own interaction with real estate tax lawyers and participation in real estate tax conferences over the last decade and a half is consistent with the evident growth of REITs. During that period of time, the number and percentage of panels and presentations that cover topics related to REITs seem to have increased significantly. Fifteen years ago, a panel discussion about REITs by members of the tax bar was a rarity. Now such panels appear to be part of every serious real estate tax conference or meeting. And more attorneys appear to have REIT work than in the recent past. REITs are now a part of mainstream tax practices of major law and accounting firms across the country.[25] Not surprisingly, REITs also have a trade organization,

25. Numerous law and accounting firms tout their REIT practices on their websites. *See, e.g.*, Alston & Bird LLP, *Real Estate & REITs*, http://www.alston.com/services/industries/real-estate-reits/; Chapman and Cutler LLP, *Real Estate Investment Trusts (REITs)*, http://www.chapman.com/practices-Real-Estate-Investment-Trusts-REITs.html; Deloitte, *It Still Ain't Easy Being Green—For a REIT: A Discussion of Selected Tax Developments and Considerations*, http://www2.deloitte.com/us/en/pages/energy-and-resources/articles/it-still-aint-easy-being-green-for-a-real-estate-investment-trust.html; EY, *Global Perspectives: 2014 REIT Report*, http://www.ey.com/Publication/vwLUAssets/EY-global-perspectives-2014-reit-report/$FILE/EY-global-perspectives-2014-reit-report.pdf; Greenberg Traurig, LLP, *Real Estate Investment Trusts (REITs)*, http://www.gtlaw.com/Experience/Industries/Real-Estate-Investment-Trusts-REITs; Holland & Knight LLP, *Real Estate Investment Trusts (REITs)*, http://www.hklaw.com/Practices/Real-Estate-Investment-Trusts-REITs/; KPMG, *Unlocking the Value Hidden in Real Estate Holdings: REIT Conversions*, http://www.kpmginfo.com/reit/; PwC, *Roadmap for a REIT IPO or Conversion for Traditional and Non-Traditional Real Estate Companies*, *at*

the National Association of Real Estate Investment Trusts (NAREIT), which has been in existence since 1960,[26] the year Congress created the REIT regime.[27] In short, the REIT industry is well established.

Despite the popularity of REITs among investors and the real estate industry, reporters' dislike of them, and lawmakers' expressed desire to curtail the scope of the REIT regime, relatively little legal scholarship focuses on REITs. That is surprising because other academic disciplines recognize that "[r]egulatory changes and the sheer growth of the industry render REITs an interesting forum for academic inquiry."[28] In fact hundreds of articles relating to REITs are published in accounting, finance, and economics journals, including articles in the leading journals of each of those disciplines,[29] with

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http://www.pwc.com/us/en/asset-management/real-estate/reit-ipo-conversion-non-traditional-reit-transaction-guidebook.jhtml; Reed Smith LLP, *Real Estate Investment Trusts (REITs)*, http://www.reedsmith.com/Real-Estate-Investment-Trusts-REIT-Practices/; Sidley Austin LLP, *REITs*, http://www.sidley.com/reits/; Shearman & Sterling LLP, *REITs*, http://www.shearman.com/en/services/industries/reits; Skadden, Arps, Slate, Meagher & Flom LLP, *Real Estate Investment Trusts*, https://www.skadden.com/practice/corporate/real-estate-investment-trusts; Sullivan & Worcester, *REITs*, http://www.sandw.com/practices-area-12.html.

26. *See* REIT.com, *REIT Industry Timeline*, https://www.reit.com/investing/reit-basics/reit-industry-timeline#1; REIT.com, *NAREIT—National Association of Real Estate Investment Trusts*, https://www.reit.com/nareit.

27. *See* Pub. L. No. 86-779, 74 Stat. 998 (1960).

28. *See* Zhilan Feng et al., *An Overview of Equity Real Estate Investment Trusts (REITs): 1993–2009*, 19 J. REAL EST. LITERATURE 307, 308 (2011) [hereinafter Feng et al., *Overview*].

29. *See, e.g.*, Jay C. Hartzell et al., *The Role of Corporate Governance in Initial Public Offerings: Evidence from Real Estate Investment Trusts*, 51 J.L. & ECON. 539 (2008) [hereinafter Hartzell et al., *Role of Corporate Governance*] (examining corporate governance and REIT IPOs); Bok Baik et al., *Reliability and Transparency of Non-GAAP Disclosures by Real Estate Investment Trusts (REITs)*, 83 ACCT. REV. 271 (2008) [hereinafter Baik, et al., *Reliability and Transparency*] (analyzing REIT disclosure); William M. Gentry et al., *Dividend Taxes and Share Prices: Evidence from Real Estate Investment Trusts*, 58 J. FIN. 261 (2003) [hereinafter Gentry et al., *Dividend Taxes*] (examining REIT dividends); Jarl G. Kallberg et al., *The Value Added from Investment Managers: An Examination of Funds of REITs*, 35 J. FIN. & QUANTITATIVE ANALYSIS 387 (2000) [hereinafter Kallberg et al., *An Examination of Funds*] (analyzing investment-manager effect); David T. Brown, *Liquidity and Liquidation: Evidence from Real Estate Investment Trusts*, 55 J. FIN. 469 (2000) [hereinafter Brown, *Liquidity and Liquidation*] (studying REIT liquidity); David C. Ling & Michael Ryngaert, *Valuation Uncertainty, Institutional Involvement, and the Underpricing of IPOs: The Case of REITs*, 43 J. FIN. ECON. 433 (1997) [hereinafter Ling & Ryngaert, *Valuation Uncertainty*] (examining institutional involvement in REIT IPOs); Jeffrey F. Jaffe, *Taxes and the Capital Structure of Partnerships, REITs, and Related Entities*, 46 J. FIN. 401 (1991) [hereinafter Jaffe, *Capital Structure*] (analyzing tax and capital structure of REITs and other entities); John S. Howe &

evidence that the interest in those disciplines is increasing.[30] Academic articles in those other disciplines cover a very wide range of topics,[31] but articles about REITs appear with significantly less frequency in law reviews, and almost none of such articles are authored by full time legal scholars.[32] Consequently,

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James D. Shilling, *Capital Structure Theory and REIT Security Offerings*, 43 J. FIN. 983 (1988) [hereinafter Howe & Shilling, *Capital Structure Theory*] (studying the capital structure and security offerings of REITs); Paul R. Allen & C.F. Sirmans, *An Analysis of Gains to Acquiring Firm's Shareholders: The Special Case of REITs*, 18 J. FIN. ECON. 175 (1987) [hereinafter Allen & Sirmans, *Special Case*] (examining REIT mergers and acquisitions).

30. *See, e.g.*, Feng et al., *Overview*, *supra* note 28, at 308 (reporting that 400 published and unpublished REIT papers during the fifteen years prior to mid-2009, including 175 written between 2005 and mid-2009); J.B. Corgel et al., *Real Estate Trusts: A Review of the Financial Economics Literature*, 3 J. REAL EST. LITERATURE 13 (1995) (citing 115 published and unpublished REIT papers published between 1980 and the publication of their 1995 paper).

31. *See, e.g.*, Hartzell et al., *Role of Corporate Governance*, *supra* note 29 (examining corporate governance and REIT IPOs); Baik et al., *Reliability and Transparency, supra* note 29 (analyzing REIT disclosure); Gentry et al., *Dividend Taxes*, *supra* note 29 (examining REIT dividends); Jarl G. Kallberg et al., *An Examination of Funds*, *supra* note 29 (analyzing investment-manager effect); Brown, *Liquidity and Liquidation*, *supra* note 29 (studying REIT liquidity); Ling & Ryngaert, *Valuation Uncertainty*, *supra* note 29 (examining institutional involvement in REIT IPOs); Jaffe, *Capital Structure, supra* note 29 (analyzing tax and capital structure of REITs and other entities); Howe & Shilling, *Capital Structure Theory*, *supra* note 29 (studying the capital structure and security offerings of REITs); Allen & Sirmans, *Special Case*, *supra* note 29 (examining REIT mergers and acquisitions).

32. The relatively few articles (many of which are excellent student notes or comments) that appear in legal journals focus on relatively narrow issues and are almost exclusively written by authors who are not fulltime academics. *See, e.g.*, Emily Cauble, *Taxing Publicly Traded Entities*, ____ (in progress, on file with author) [hereinafter Cauble, *Publically Traded*]; Bradley T. Borden, *Reforming REIT Taxation (Or Not)*, ____ (in progress, on file with author); Simon Johnson, *Reinvigorating the REIT's Neutrality and Capital Formation Purposes Through a Modernized Tax Integration Model*, 7 J. BUS. ENTREPRENEURSHIP & L. 63 (2013) (arguing that Congress should reform REIT taxation to improve the capitalization rules that currently require REITs to distribute almost all of their taxable income); Carson Siemann, *Promoting Equity for REIT Investors*, 36 SETON HALL LEGIS. J. 271 (2012) (recounting the history of REIT taxation and arguing that lawmakers should modify REIT taxation to incorporate aspects of partnership taxation); Simon Johnson, *Has the Time for Large Gaming Property Involved REITs Finally Arrived?: A Review of the Potential for REIT Investment in Destination Gaming Resort Properties*, 2 UNLV GAMING L.J. 47 (2011) (focusing on REITs in the gaming industry); William J. Daly, *A Comparative Analysis of the New Real Estate Investment Trust Legislation in Germany and the United Kingdom: Will Those Markets Experience the Same Success as the United States?*, 17 TRANSNAT'L L. & CONTEMP. PROBS. 839 (2008) (comparing the REIT regimes of the United States, Germany, and the United Kingdom); Julius L.

Sokol, *The Proliferation of Global REITs and the Cross-Borderization of the Asian Market*, 9 SAN DIEGO INT'L L.J. 481 (2008) (focusing on Asian REIT market); Staffaroni, *Foreign Investors*, *supra* note 20 (discussing the tax aspects of RICs and REITs and the tax consequences of foreign investment in such arrangements); Jennifer Stonecipher, Note, *From One Pocket to the Other: The Abuse of Real Estate Investment Trusts Deductions*, 72 MO. L. REV. 1455 (2007) (addressing a loophole in state tax rules that allow operating companies to generate deductions by circulating money through a REIT and holding company); Nathan C. Brown, Comment, *Real Estate Investment Trusts and Subpart F: Characterizing Subpart F Inclusions for Purposes of the REIT Income Tests*, 20 EMORY INT'L L. REV. 833 (2006) (considering whether earnings of a foreign corporation should be treated as dividends for the REIT income tests, if the REIT is a shareholder of the foreign corporation); Louis J. Zivot, *The Evolution of a REIT Rule: Impermissible Tenant Service Income*, 33 REAL EST. L.J. 54 (2004) (discussing changes to the restrictions on services that a REIT can provide tenants); Charles E. Wern III, Comment, *The Stapled REIT on Ice: Congress' 1998 Freeze of the Grandfather Exception for Stapled REITs*, 28 CAP. U. L. REV. 717 (2000) (examining legislation that curtailed the use of stapled and paired-share REITs); David M. Einhorn et al., *REIT M&A Transactions—Peculiarities and Complications*, 55 BUS. LAW. 693 (2000) (discussing mergers and acquisitions of REITs); David M. Einhorn, *Unintended Advantage: Equity REITs vs. Taxable Real Estate Companies*, 51 TAX LAW. 203 (1998) (discussing the then-current practices of REITs); Chadwick M. Cornell, Comment, *REITs and UPREITs: Pushing the Corporate Law Envelope*, 145 U. PA. L. REV. 1565 (1997) (describing UPREIT structures and the benefits that investors derive from using them); Russell J. Singer, Note, *Understanding REITs, UPREITs, and Down-REITs, and the Tax and Business Decisions Surrounding Them*, 16 VA. TAX. REV. 329 (1996) (focusing on particular REIT structures); Note, *Managing the Real-Estate Investment Trust: An Alternative to the Independent Contractor Requirement*, 107 HARV. L. REV. 1117 (1994) (discussing the rules governing the types of services that REITs can provide directly or through contractors); Sarah G. Austrian & Willys H. Schneider, *Tax Aspects of Foreign Investment in U.S. Real Estate*, 45 TAX LAW. 385 (1992) [hereinafter Austrian & Schneider, *Tax Aspects*] (discussing the tax consequences to foreign investors of investing in U.S. real estate and withholding obligations of U.S. persons related to foreign investments); William L. Martin, II, *Federal Regulation of Real Estate Investment Trusts: A Legislative Proposal*, 127 U. PA. L. REV. 316 (1978) (proposing legislation that would put REITs and RICs on similar ground); James S. Halpern, *Real Estate Investment Trusts and the Tax Reform Act of 1976*, 31 TAX LAW. 329 (1978) (reviewing the changes brought about by the 1976 REIT legislation); Mitchell N. Baron, *The Tax Status of REITs: A Reassessment*, 9 COLUM. J.L. & SOC. PROBS. 166 (1973) (arguing that the REIT requirements should be relaxed to help additional capital to flow to low-income housing); William J. Kelley, Jr., *Real Estate Investment Trusts After Seven Years*, 23 BUS. LAW. 1001 (1968) (revisiting REIT taxation shortly after the enactment of the REIT regime); John K. MacDonald, *Real Estate Investment Trusts under the Internal Revenue Code of 1954: Proposals for Revision*, 32 GEO. WASH. L. REV. 808 (1964) (discussing the then-recently-enacted REIT regime); Theodore Lynn, *Real Estate Investment Trusts: Problems and Prospects*, 31 FORDHAM L. REV. 73 (1962) (discussing the then-newly-enacted REIT tax regime);

no legal academic article has given serious thought to the tax-revenue effect of REIT taxation, whether tax policy justifies REIT spinoffs, the cause of growth of the REIT industry, or whether granting favorable tax treatment to entities that hold real estate is advisable in today's environment. Consequently, REITs warrant more academic legal attention. This Article is the first to examine comprehensively the tax-revenue effect of REITs. The conclusions presented in this Article are counterintuitive, revealing that REITs are generally misunderstood, and more academic policy and tax-law analysis will benefit this area of law.

Based upon the graphs in Figures 1 and 2 and an understanding that REITs are not subject to an entity-level tax, intuition suggests that the growth of REITs is seriously eroding the corporate tax base and causing the government to lose tax revenue. This Article is the first to attack that intuition and shows that the tax-revenue effect of REIT spinoffs is the product of at least eight variables[33]—the least important of which appears to be corporate-tax-base erosion[34]—and, depending upon the values of those variables, a REIT spinoff could counterintuitively increase the government's tax revenue.[35] The Article is also the first to explain the counterintuitive tax-revenue effect of REITs forming from partnerships. Partnerships are flow-through entities, so they are not subject to entity-level tax.[36] Intuition therefore suggests that REITs forming from partnerships would not have negative tax-revenue effects. This Article challenges that thinking and proves that REITs that form from partnerships can erode the "partnership tax base," i.e., taxable income that would otherwise be subject to the partnership tax regime. That erosion causes the government to lose more tax revenue than it loses from REIT spinoffs.

John C. Dawson, Jr., Comment, *The Real Estate Investment Trust*, 40 TEX. L. REV. 886 (1962) (discussing the recently-enacted REIT tax regime); Dudley J. Godfrey, Jr. & Joseph M. Bernstein, *The Real Estate Investment Trust—Past, Present and Future*, 1962 WIS. L. REV. 637 (1962) (providing a contemporary account of the original REIT legislation); J. B. Riggs Parker, *REIT Trustees and the "Independent Contractor"*, 48 VA. L. REV. 1048 (1962) (describing how the federal tax restriction on services that a REIT may provide could be contrary to the state fiduciary duties imposed on trustees of real estate trusts); Marvin S. Kahn, *Taxation of Real Estate Investment Trusts*, 48 VA. L. REV. 1011 (1962) (discussing the effect REIT taxation had on the use of business trusts); John P. Carroll, Jr., *Tax Policy for Real Estate Investment Trusts*, 28 TAX L. REV. 299 (1972) (discussing policy aspects of several of the REIT requirements); Joseph Taubman, Note, *The Land Trust Taxable as Association*, 8 TAX L. REV. 103 (1952) (discussing the tax status and treatment of land trusts prior to enactment of the REIT legislation).

33. *See infra* Part B.

34. *See infra* text accompanying notes 241–242.

35. *See* Bradley T. Borden, *Counterintuitive Tax Revenue Effect of REIT Spinoffs*, 146 TAX NOTES 381, 82–84 (2015) (considering how dividend-payout ratios affect the tax-revenue effect of REIT spinoffs).

36. *See* I.R.C. § 701; *infra* text accompanying notes 55–59.

The Article proceeds as follows. Part II details the difference between corporate taxation, REIT taxation, and partnership taxation. Even though neither partnerships nor REITs are subject to an entity-level tax, tax law treats them differently in other ways. The nuanced differences between corporations, REITs, and partnerships cause unanticipated tax-revenue results. Part III examines the tax-revenue effect of a single REIT spinoff. That careful examination identifies variables that influence the tax-revenue effect of a REIT spinoff. Conventional analyses fail to account for those variables and nuances in the law, but this Article introduces a dynamic analysis that accounts for the nuances and overcomes inaccurate intuition. The analysis proves both analytically and mathematically that even though REIT spinoffs erode the corporate tax base, they could cause tax revenue to increase because other variables, such as shareholder tax rates, corporate dividend-payout ratios, and shareholder composition, influence the tax-revenue effect of REIT spinoffs. Part IV expands the analysis to estimate the aggregate effect of REIT spinoffs and the tax-revenue effect of REITs forming from partnerships. The analysis shows that REITs forming from partnerships influence tax revenue significantly more than REIT spinoffs. Part V concludes with a recommendation that accurate estimates of tax-revenue effect of REIT taxation should inform reform discussions and provides general comments about the possible direction of tax-revenue-effective REIT reform.

II. CORPORATE, CONDUIT, AND FLOW-THROUGH TAXATION

The tax-revenue effect of REIT spinoffs and REIT taxation depends to a significant extent on the various tax regimes (i.e., corporate, REIT, and partnership) that can apply to real estate ownership. A brief discussion of corporate, REIT, and partnership taxation therefore helps set the stage for examining the tax-revenue effect of REITs. Corporations, REITs, and partnerships are similar in two general respects—each type of entity can own property and perform some services with respect to property, and each type of entity has owners (typically shareholders in the case of corporations and REITs, and partners in the case of partnerships).[37] Nonetheless, the three types of entities are each subject to different tax regimes: corporations are subject to entity taxation, REITs are subject to conduit taxation, and partnerships are subject to flow-through taxation.[38] Because corporations are subject to entity

37. This discussion uses the term "corporation" to refer to any type of entity that is subject to U.S. corporate income tax under I.R.C. § 11 (2012). Such entities can include state-law corporations and electing state-law partnerships and limited liability companies. *See* Reg. § 301.7701-1 to -3. The discussion uses the term "partnership" to refer to any entity that is subject to partnership taxation, which includes state-law partnerships and limited liability companies by default. *See id.*

38. *See infra* text accompanying notes 55–59.

taxation, the tax treatment of corporations appears to be less favorable to taxpayers than the treatment of REITs and partnerships, but various nuances make the regimes different in numerous ways and provide each its own set of advantages and disadvantages.

Generally, corporations must pay tax on income they recognize.[39] If a corporation distributes after-tax income to its shareholders, the shareholders generally must pay tax on the distribution.[40] Thus, distributed corporate income is subject to two levels of tax—the entity-level tax paid by the corporation and a shareholder-level tax paid by the shareholders. Contrast that treatment with the treatment afforded REITs and their shareholders. If a REIT distributes at least 90 percent of its taxable income, the distributed income is not subject to an entity-level tax.[41] Instead, REIT shareholders report their respective shares of the REIT taxable income that flows through with the REIT distribution in their taxable income.[42] Because REIT taxable income flows through to REIT shareholders, REITs are commonly referred to as conduit entities, and distributed REIT taxable income is subject to a single level of tax (shareholder-level tax). Partnership income also flows through to partners, but partnerships do not have a distribution requirement and have greater latitude for allocating tax items.[43] Other rules also make REITs, corporations, and partnerships different from each other.

Corporations and REITs differ in other more nuanced ways. To avoid the entity-level tax, REITs must distribute at least 90 percent of their taxable

39. *See* I.R.C. § 11(a). An exception to this general rule is S corporations, which are not subject to an entity-level tax. *See* I.R.C. § 1363(a).

40. *See* I.R.C. § 61(a)(7) (including dividends in the definition of gross income); *See* I.R.C. § 301(c) (defining dividends). Some institutional shareholders may be exempt from tax and would not pay tax on corporate dividends. *See* I.R.C. § 501(a) (2012) (exempting organizations such as charities, churches, educational institutions, and retirement funds from taxation). *See also* I.R.C. § 512(b)(1) (excluding dividends from the definition of unrelated business taxable income).

41. *See* I.R.C. § 857(a)(1)(A)(i), (b)(1), (b)(2).

42. *See* I.R.C. § 61(a)(7) (including dividends in gross income); I.R.C. § 301(c) (defining dividend); I.R.C. § 857(b)(3)(B) (providing that a portion of a REIT dividend can be treated as long-term capital gain, if it represents capital gain recognized by the REIT); Reg. § 1.857–6 (requiring REIT shareholders to recognize income in the year they receive a REIT dividend and describing how to compute the amount of income). Income distributed to a tax-exempt REIT shareholder generally would not be subject to income tax. *See supra* note 40.

43. *See* I.R.C. § 704(b); Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. CIN. L. REV. 1077 (2011); Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 TAX LAW. 97 (2010); Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465 (2011).

income,[44] but corporations are not subject to a distribution requirement. Corporations can therefore avoid subjecting their income to double tax by reinvesting the income and not making distributions. In fact, in practice corporations distribute no more than 25 percent of their taxable income on average.[45] Tax law also taxes dividends from corporations and REITs differently. Dividends from corporations to individuals can come within the definition of "qualified dividend income" and qualify for preferential capital gain tax rates.[46] Assuming the highest capital gains rate and Medicare surtax apply to corporate dividends, the tax rate on a typical corporate dividend paid to an individual includes the 20 percent qualified-dividend-income rate and

44. *See* I.R.C. § 857(a)(1)(A) (excluding net capital gains). Even though the requirement does not require REITs to distribute all of their capital gains, they typically do. *See infra* note 311 and accompanying text.

45. *See* Michael Amenta, Dividend Quarterly, FactSet (Sep. 15, 2014), http://www.factset.com/websitefiles/PDFs/dividend/dividend_9.15.14 (claiming that the dividend payout ratio for the S&P 500 companies was 32.3 percent for the second quarter of 2014, the highest non-recession level in ten years). The dividend payout ratio is calculated by dividing dividends by net income. *See Definition of "Dividend Payout Ratio,"* Investopedia, http://www.investopedia.com/terms/d/dividend payoutratio.asp. Corporate net income is usually less than corporate taxable income. For example, at the end of 2011, corporate net income was $698 billion and corporate taxable income was $931 billion. *See Statistics on Income Tax Stats—Table 16: Returns of Active Corporations, Form 1120*, (2011), http://www.irs.gov/file_source/pub/irs-soi/11co16ccr.xls. Assuming a 32.3 percent payout ratio, dividends would have been 24.22 percent of the 2011 taxable income ($698 billion × 32.3 percent ÷ $931 billion). In fact, Windstream announced that it would reduce its dividends at the same time it announced that it would spin off its real estate assets. *See Windstream REIT Spinoff Plan Provides Jolt for Stock, Telecom Sector*, THE STREET (July 29, 2014), http://www.thestreet.com/story/12825280/1/windstream-reit-spinoff-plan-provides-jolt-for-stock-telecom-sector.html (reporting that Windstream was cutting its overall dividend from $1 to $0.7 ($0.1 from the corporation and $0.6 from the REIT)).

46. *See* I.R.C. §§ 1(h)(1)(D), (h)(11). The analysis assumes all shareholders are individuals, unless stated otherwise. Nonetheless, a significant percentage of corporate and REIT stock is held directly (or indirectly through mutual funds) by tax-exempt retirement accounts. *See* Marshall E. Blume & Donald B. Keim, *Institutional Investors and Stock Market Liquidity: Trends and Relationships*, working paper (2012), http://www.wharton.upenn.edu/jacobslevycenter/files/14.12.keim.pdf [hereinafter Blume & Keim, *Trends and Relationships*] (estimating that as much as 67 percent of all corporate stock is held by institutional investors). For the sake of comparison at this point of the analysis, this Article assumes that all of the corporate and REIT stock is held by individuals in the highest marginal tax brackets. The analysis below considers the effect of ownership by tax-exempt institutional and foreign investors. *See infra* Part III.B.3.

the 3.8 percent Medicare surtax, for a total tax rate of 23.8 percent.[47] The highest corporate tax rate is 35 percent.[48] Because corporations distribute taxable income to shareholders net of corporate tax, the effective tax rate (assuming the highest tax rates apply and that the corporation distributes 100 percent of its after-tax taxable income) on distributed corporate taxable income is 50.47 percent.[49] Running the analysis assuming that a corporation distributes only 25 percent of its taxable income, the effective tax rate of taxable income from property held by the corporation becomes 40.95 percent.[50] The lower dividend-payout ratio reduces the effective tax rate by 9.52 percentage points, a difference that can cause a REIT spinoff to generate positive tax revenue. The lower effective tax rate results because only a portion of the corporation's after-tax taxable income is subject to double tax.

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47. *See* I.R.C. § 1(h)(1)(D) (providing the preferential 20 percent rate); I.R.C. § 1411(a), (c)(1)(A)(i) (imposing the 3.8 percent Medicare surtax on certain types of income, including dividend income).

48. *See* I.R.C. § 11(b). For the most part, the analysis in this Article uses the statutory corporate tax rate, even though the effective rate could be much lower than 35%. *See, e.g.*, William McBride, *GAO Still Underestimating Corporate Effective Tax Rate*, TAX FOUNDATION TAX POLICY BLOG (Dec. 2, 2013), http://taxfoundation.org/blog/gao-still-underestimating-corporate-effective-tax-rate (claiming the effective tax rate is around 26 percent); Martin A. Sullivan, *Behind the GAO's 12.6 Percent Effective Corporate Rate*, 140 TAX NOTES 197, 199 (July 15, 2013) (challenging the GAO report and concluding that the "average worldwide effective corporate tax rates are somewhere in the mid- or upper 20s"); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-520, REPORT TO CONGRESSIONAL REQUESTERS—CORPORATE INCOME TAX: EFFECTIVE TAX RATES CAN DIFFER SIGNIFICANTLY FROM THE STATUTORY RATE 14 (2013), http://www.gao.gov/assets/660/654957.pdf (reporting that the effective U.S. federal corporate income tax rate of profitable corporations was 12.6 percent in 2010, the last year for which the GAO had information prior to doing its report).

49. The formula for computing this rate is $(1 \times 0.35) + ((1 - 0.35) \times 0.238)$.

50. The formula for computing this rate, which assumes the corporation distributes 25 percent of its taxable income, is $(1 \times 0.35) + (0.25 \times 0.238)$. Corporations can be subject to an accumulated earnings tax equal to the ordinary income tax rate imposed on qualified dividend income. *See* I.R.C. § 531 (imposing the tax on accumulated earnings); *supra* note 47 (discussing the ordinary tax rate imposed on qualified dividend income). The accumulated earnings tax is imposed on corporations that avoid the tax on shareholder dividends by not distributing earnings. *See* I.R.C. § 532(a). Corporations are deemed to hold earnings to avoid the tax on shareholders if they accumulate earnings beyond the reasonable needs of the corporation. *See* I.R.C. § 533(a). With proper planning, corporations should be able to justify retaining earnings and avoid the accumulated earning tax. *See* Gary L. Maydew, *Substantiation Helps Avoid Accumulated Earnings Tax*, 55 TAX'N FOR ACCT. 23 (1995). Consequently, this analysis assumes that the average corporate distribution is sufficient to avoid the accumulated earnings tax.

On the other hand, dividends from REITs do not qualify for the qualified-dividend-income favorable tax rate.[51] Consequently, REIT dividends are subject to ordinary income rates, unless they include capital gains recognized by the REIT.[52] Assuming the highest ordinary individual tax rate of 39.6 percent applies to REIT shareholders and the REIT dividends are subject to the 3.8 percent Medicare surtax, ordinary REIT taxable income is subject to a 43.4 percent tax rate.[53] This suggests that REIT shareholders enjoy a 6.67 percentage point advantage over corporate shareholders if a corporation distributes 100 percent of its after-tax income. If the corporation distributes only 25 percent of its taxable income, however, the REIT shareholders suffer a 2.85 percentage point tax disadvantage. This is a counterintuitive aspect of REIT taxation that other reporters, commentators, and analysts appear to overlook.[54]

An analysis of the tax-revenue effect of REIT taxation is incomplete if it fails to compare REIT taxation to partnership taxation. Often property owners own real estate in partnerships. Partnerships are not subject to income tax.[55] Instead, partnerships compute taxable income and other tax items and allocate them to the members of the partnership.[56] The members of partnerships report their proportionate shares of those items on their respective tax returns and pay tax on the items as appropriate.[57] The character of tax items, as determined at the partnership level, carries through to the partners.[58] Consequently, capital gain recognized by a partnership would flow through to the members of the partnership as capital gain, and the partnership's ordinary income would flow through to the members as ordinary income. Partnerships

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51. *See* I.R.C. § 857(c)(2)(B).

52. *See* I.R.C. § 857(b)(3); *infra* text accompanying note 311 (providing information about the average percentage of REIT distributions that are capital gain dividends); *infra* Part IV.B. (accounting for capital gain dividends in an analysis of the overall effect REIT taxation might have on tax revenue). The analysis at this point disregards the capital-gain portion of REIT dividends.

53. *See* I.R.C. § 1(a)–(c) (providing that the highest effective tax rate on ordinary income for an individual is 39.6 percent); I.R.C. § 1441(a) (2012). A portion of the REIT dividend can be capital gains subject to the 23.8 percent rate. *See supra* note 42. At this point, the analysis assumes the entire REIT dividend is ordinary income. Subsequent analyses assume the REIT dividends include both ordinary income and capital gain. *See, e.g.*, *infra* text accompanying notes 311–429.

54. *See supra* notes 1, 4, 7; *infra* notes 106, 282. *But see* Austan Goolsbee & Edward Maydew, *Taxes and Organizational Form: the Case of REIT Spin-Offs*, 55 NAT'L TAX J. 441, 443 (2002) [hereinafter Goolsbee & Maydew, *Organizational Form*] (taking shareholder tax rates and the REIT distribution requirement into account).

55. *See* I.R.C. § 701.

56. *See* I.R.C. §§ 702, 703, 704.

57. *See* I.R.C. §§ 701, 702.

58. *See* I.R.C. § 702(b).

are not subject to a distribution requirement, but members of partnerships must report partnership income even if the partnership does not distribute it.[59] The tax rate on ordinary real estate income allocated to a passive individual member of a partnership is 43.4 percent, and allocated partnership capital gain allocated to a passive individual member of a partnership qualifies for the favorable 23.8 percent tax rate on capital gains at the individual member level.[60] Operating losses can also flow through to members of partnerships and offset income they have from other sources.[61] That is not, however, the case with REITs, which cannot pass net losses through to their shareholders.[62] Table 1 summarizes the different treatment of corporate, REIT, and partnership taxable income.[63]

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59. *See* United States v. Basye, 410 U.S. 441 (1973) (requiring partners to recognize undistributed partner income).

60. *See supra* text accompanying notes 48–54 (describing the income tax rates).

61. Partners can only recognize such losses to the extent that the basis they have in their partnership interest. *See* I.R.C. § 704(d).

62. *See* MCCALL, LEGAL BASICS, *supra* note 15, at 6.

63. The discussion below provides a more in-depth comparison of REIT and partnership taxation. *See infra* Part IV.C. It also briefly mentions some similarities between REITs and publicly traded partnerships. *See infra* text accompanying note 354.

Table 1: Summary of Tax Treatment of Various Real Estate Ownership Arrangements			
	Corporation	**REIT**	**Partnership**
Top Entity-Level Tax Rate	35%	None	None
Distribution Requirement	None	90% of taxable income	None
Top Tax Rate on Distribution	23.8%	43.4%	N/A
Treatment of Undistributed Taxable Income	Taxed at 35%	Taxed at 35%	Taxable to partners at 43.4%
Effective Tax Rate on Ordinary Taxable Income (assuming corporation distributes 100% of after-tax taxable income)	50.47%	43.4%	43.4%
Effective Tax Rate on Ordinary Taxable Income (assuming corporation distribute 25% of taxable income)	40.95%	43.4%	43.4%
Flow Through of Net Operating Losses?	No	No	Yes

This summary makes numerous simplifying assumptions (the analysis below will alter some of them[64]) that affect the computation of the effective tax rates, but it shows generally that the erosion of the corporate tax base through a REIT spinoff may not necessarily result in lower tax revenue. If a corporation's dividend-payout ratio is 25 percent or less under the current assumptions, income from real estate is subject to the lowest tax rate if held by the corporation. This counterintuitive result obtains because corporations are taxed at a lower rate than individuals, corporations do not distribute 100 percent of their after-tax taxable income, REIT dividends are subject to the highest tax rate, and REITs are subject to a distribution requirement. The results will nonetheless vary as assumptions change. For example, portions of REIT dividends may qualify for favorable capital gains rates,[65] and tax-exempt investors could hold portions of both corporate and REIT stock.[66] By considering these and other variations, the analysis below illustrates that the

64. *See infra* Parts III.B., III.C, IV.

65. *See supra* note 42 (describing the tax treatment of REIT dividends); *infra* text accompanying notes 311 (describing the composition of distributions from publicly-traded REITs).

66. *See infra* text accompanying notes 169–174.

erosion of the corporate tax base can be less important than other variables when considering the tax-revenue effect of REIT taxation. The focus on erosion of the corporate tax base is thus misplaced.

III. TAX-REVENUE EFFECT OF A SINGLE REIT SPINOFF

An example of a REIT spinoff, patterned after the recently-announced Windstream spinoff in very general terms,[67] illustrates the effect a REIT spinoff can have on tax revenue of a single corporation and its shareholders. REIT spinoffs, like the Windstream spinoff, typically require an existing corporation (Op Corp) to contribute real estate assets to a newly-formed corporation that is wholly owned by Op Corp.[68] Op Corp then distributes (i.e., spins off) all of the shares in the newly-formed corporation to its shareholders in proportion to their ownership interests in the Op Corp.[69] The newly-formed corporation elects to be a REIT.[70] Immediately following the spinoff, the shareholders hold stock in both Op Corp and the new REIT, and Op Corp leases the real estate from the REIT.[71] REIT spinoffs are subject to the general corporate reorganization tax rules and can be tax free,[72] but they do not free

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67. *See* News Release, *Windstream to Spin Off Assets Into Publicly Traded REIT* (July 29, 2014), http://news.windstream.com/article_display.cfm?article_id=1561 (providing that Windstream Holdings Inc., a provider of advanced network communications, would spin off its fiber and copper networks and other real estate and $3.2 billion of debt into a REIT and thereafter pay $650 million per year to lease the assets).

68. *See* P.L.R. 2014-11-002 (Dec. 13, 2013) (granting favorable tax treatment to a complex REIT splitoff (i.e., a distribution of the REIT that is not in proportion to the ownership of the distributing corporation)); P.L.R. 2013-37-007 (Sept. 28, 2012) (granting favorable tax treatment to complex REIT spinoff); Andrea Macintosh Whiteway et al., *REIT (Real Estate Investment Trusts) Spin-Offs: Recent Transactions and IRS Rulings* THE NATIONAL LAW REVIEW (Nov. 12, 2014), http://www.natlawreview.com/article/reit-real-estate-investment-trusts-spin-offs-recent-transactions-and-irs-rulings (describing aspects of recent REIT spinoffs). This analysis refers to the entity considering or doing a REIT spinoff as "corporation." Thus, the corporation is the entity that is doing the spinoff, and the REIT is the entity that the corporation spins off. Any comparisons to a corporation and a REIT are to arrangements that would be subject to corporate taxation and those that would be subject to REIT taxation, respectively.

69. *See* P.L.R. 2014–11–002 (Dec. 13, 2013) and P.L.R. 2013–37–007 (Sept. 28, 2012).

70. *See id.*

71. *See id.*

72. An important part of the spinoff rules is that both the corporation and the REIT be engaged in an active trade or business immediately following the spinoff. *See* I.R.C. § 355(b)(1)(A). The IRS has ruled that some REITs can satisfy this requirement, even though their income is generally passive. *See* Rev. Rul. 2001–29,

pre-spinoff corporate income from double tax.[73] The following discussion illustrates the operation of the REIT spinoff rules, showing that the tax-revenue effect of REIT spinoff has both a transactional component (the tax aspects of the spinoff itself) and an operational component (the tax treatment of the REIT following the spinoff).

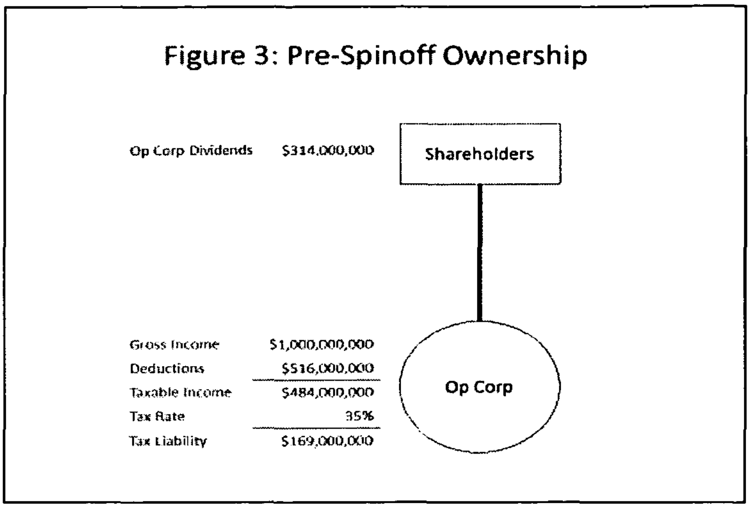
A. Fundamentals of REIT Spinoffs

The analysis begins by illustrating the fundamentals of REIT spinoffs.[74] Assume Op Corp, a publicly-traded corporation, holds $6 billion of real estate assets. Op Corp's adjusted tax basis in that property is $3.3 billion, and the property is subject to a $3.2 billion liability that the REIT will assume as part of the spinoff. Op Corp estimates that $1 billion of its gross income derives from its real estate. Its interest deduction on the $3.2 billion liability is $128 million, and its depreciation deduction for the property is $388 million.

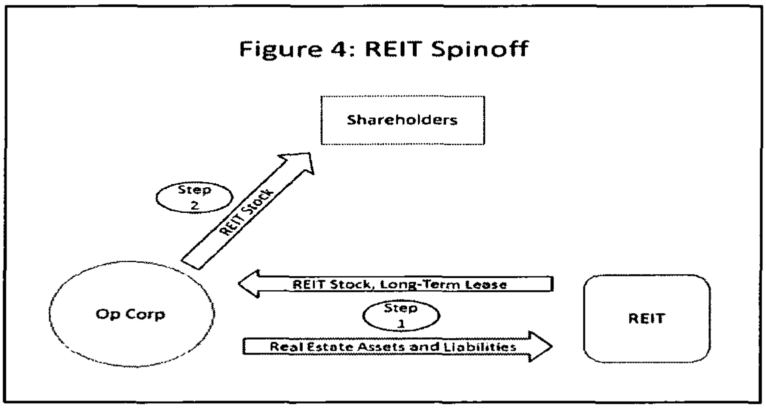
2001–1 C.B. 1348. Nonetheless, discussions of REIT spinoffs still focus on the active-business requirement. *See, e.g.*, Robert Rizzi, *Real Estate and Spinoffs: Revisiting Plum Creek*, 40 J. CORP. TAX'N 50 (2013). REITs generally satisfy the active-business requirement through the activities of taxable REIT subsidiaries. *See* Richard M. Nugent, *Passive REITs, Active Business: A Primer on REIT Spinoffs*, Tax Forum No. 662 (Jan. 15, 2015) (draft) (on file with the Author) [hereinafter Nugent, *Passive REITs*].

73. *See* I.R.C. § 857(a)(2)(B); Reg. § 1.337(d)–7(b)(4) (requiring a REIT to make a purging dividend of pre-spinoff earnings and profits); Reg. § 1.337(d)–7(a)(1) (applying the rules in I.R.C. § 1374 to the built-in gain resulting from a REIT conversion of spinoff); Treas. Reg. § 1.857-11 (requiring REITs to distribute earnings and profits inherited from a spinoff or conversion). Parts III.A.1. and III.A.2. *infra* discuss purging dividends and the built-in gains tax, respectively.

74. For comprehensive coverage of the technical requirements of REIT spinoffs, see Nugent, *Passive REITs, supra* note 72. Although most corporations would use a tax-free spinoff or conversion to move real estate assets from a corporation to a REIT, a corporation could accomplish the same end result by selling the assets to a REIT and leasing them back. A corporation that is short on cash has operating losses may prefer the sale-leaseback structure. *See* Amy S. Elliott, *Sears's REIT Considerations Represent Base Erosion Threat*, 2014 TAX NOTES TODAY 217-3 (Nov. 10, 2014).



Thus, without the spinoff, Op Corp can deduct $516 million[75] from its $1 billion of revenues and would have $484 million of taxable income related to the real estate assets.[76] Assuming Op Corp's tax rate is 35 percent,[77] it will pay approximately $169 million of income tax related to the real estate assets. Assuming it distributes 100 percent of its taxable income net of the income



75. $128 million interest deduction + $388 million depreciation deduction.

76. *See* I.R.C. §§ 63(a) (defining taxable income as gross income minus deductions); 61(a)(2) (providing that gross income includes income from business); 163(a) (allowing a deduction for interest); 167(a) (allowing a deduction for depreciation). Notice that Op Corp's taxable income is less than its pre-tax cash flow. The pre-tax cash flow is $1 billion minus the $128 million interest payment, or $872 million. The depreciation deduction is part of the computation of taxable income, but it does not affect cash flow. Detailed calculations for this example are in Appendix B.

77. *See* I.R.C. § 11.

tax,[78] it could distribute at least $314 million to its shareholders.[79]

Op Corp could reduce its tax liability by spinning off its real estate assets to a REIT. To effectuate the spinoff, Op Corp would form the REIT and transfer all $6 billion of its real estate assets and the $3.2 billion liability to REIT in a tax-free formation of the REIT.[80] The REIT would take Op Corp's $3.3 billion adjusted basis in the assets,[81] so Op Corp's built-in gain (i.e., the amount of gain Op Corp would have recognized had it sold the assets for their fair market value) in those assets carries over to the REIT. Op Corp would then enter into a long-term lease with the REIT that requires Op Corp to pay $650 million per year for the exclusive use of the real estate assets. Then it would distribute the stock of REIT to its shareholders in proportion to their Op Corp shares in a tax-free spinoff (see Figure 4).

Immediately following the distribution the same shareholders would hold both Op Corp and REIT stock, and Op Corp would have a long-term lease to use the real estate assets (*see* Figure 5). The spinoff legally separates the Op Corp operations from the REIT's ownership of the real estate assets. Op Corp remains subject to corporate tax, but the REIT qualifies for REIT conduit taxation. The REIT would hold the real estate assets with the same adjusted basis and built-in gain that the Op Corp had in the assets.

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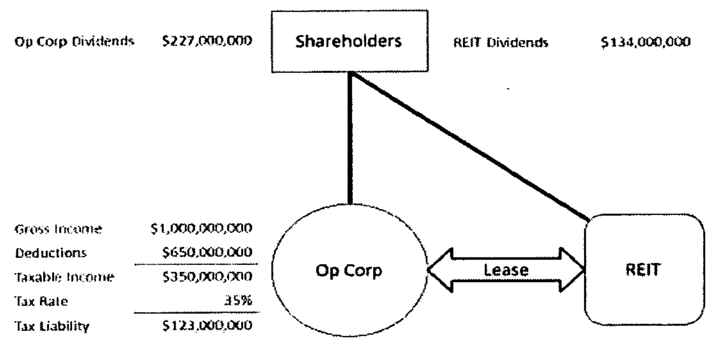
78. To create a baseline comparison, this example assumes that the corporation and REIT distribute only taxable income net of entity-level taxes. Because the corporate revenue from the property exceeds the taxable income, the corporation arguably could distribute more than the taxable income. Alternatively, because it has no requirement to make a distribution, the corporation could choose to distribute a smaller amount. Later examples consider the consequences of distributions that vary from the amount of after-tax taxable income.

79. $484 million of taxable income—$169 million of tax.

80. *See* I.R.C. § 368(a)(1)(D).

81. *See* I.R.C. § 362(a).

Figure 5: Post-Spinoff Ownership



Following the spinoff, Op Corp will continue to use the real estate assets to generate $1 billion of gross income revenue. It will deduct $650 million of rent against that revenue, so it will have $350 million of taxable income.[82] At the 35 percent rate, Op Corp would pay about $123 million of tax.[83] The REIT will own the real estate assets and hold the liability. It will have $650 million of gross income from the real estate assets and will deduct $128 million for the interest payment and $388 million for depreciation, so the REIT will have $134 million of taxable income.[84] Assuming the REIT distributes all of that taxable income to its shareholders, it will owe no income tax.[85] The spinoff thus removes $134 million of taxable income from Op Corp's tax base. The tax-revenue effect of moving that income depends upon numerous variables several of which are discussed below.[86]

This Article focuses on REIT spinoffs, but similar issues arise with respect to REIT conversions. A conversion from a corporation to a REIT occurs when an existing corporation elects to be a REIT.[87] The conversion

82. *See* I.R.C. § 63(a) (defining taxable income as gross income minus deductions); I.R.C. § 61(a)(2) (providing that gross income includes income derived from business); I.R.C. § 162(a)(3) (allowing a deduction for rental payments).

83. $350 million × 35%.

84. *See* I.R.C. § 63(a) (defining taxable income as gross income minus deductions); I.R.C. § 61(a)(5) (2012) (providing that gross income includes rents); I.R.C. § 163(a) (allowing a deduction for interest); I.R.C. § 167(a) (allowing a deduction for depreciation).

85. *See supra* text accompanying notes 41–42.

86. *See infra* Part III.B.2–4.

87. *See* P.L.R. 2013–20–007 (Feb. 11, 2013) (ruling with respect to a REIT conversion of a publicly-traded private prison company); P.L.R. 2013–17–001 (Jan.

moves taxable income from a corporation to a REIT, so it can cause corporate-tax-base erosion. The primary difference between a REIT spinoff and REIT conversion is that after a spinoff the corporation leases property from the REIT,[88] and after a conversion, the REIT probably manages the property through a taxable REIT subsidiary.[89] That difference does not alter the tax-revenue-effect analysis that follows, and the rules governing purging dividends and built-in gains apply to both REIT spinoffs and conversions.[90] Thus, the conclusions with respect to REIT spinoffs that follow should apply equally to REIT conversions.

Despite the ability to represent REIT spinoffs with a simple diagram, they are complex transactions that come with significant transaction costs and present numerous tax issues that the parties must consider.[91] For instance, although REIT spinoffs can be tax free, the law uses purging dividends and the built-in gains tax to ensure that pre-spinoff corporate income does not escape double tax.

1. *Purging Dividends*

The REIT rules provide that a REIT must distribute any earnings and profits that it accumulated prior to the formation of the REIT.[92] This requirement prevents corporations from using tax-free REIT spinoffs to take earnings and profits out of the dividing corporation tax free. This rule

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16, 2013) (ruling with respect to a conversion of a publicly-traded corrections company).

88. *See supra* text accompanying note 61.

89. *See* P.L.R. 2013–20–007 (Feb. 11, 2013); P.L.R. 2013–17–001 (Jan. 16, 2013).

90. *See* I.R.C. § 857(a)(2)(B); Reg. § 1.337(d)–7(b).

91. *See* P.L.R. 2014–11–002 (Dec. 13, 2013) and P.L.R. 2013–37–007 (Sep. 28, 2012) (presenting the facts of two very complex REIT spinoffs); Sullivan, *Economic Inefficiency*, *supra* note 4, at 1230–31 (reporting that operating costs, including expenses for legal and tax work, advisory fees, and miscellaneous costs, related to REIT conversions and spinoffs can range from $59 million to $155 million, with capital expenses in the tens of millions of dollars).

92. *See* I.R.C. § 857(a)(2)(B); *see also* Ameek Ashok Ponda, *How Much Gain Would a REIT Defer if a REIT Could Defer Gain?*, 135 TAX NOTES 1249, 1251–52 (June 4, 2012) [hereinafter Ponda, *How Much Gain*] (discussing purging dividends and the built-in gains tax). To qualify as a distribution of earnings and profits, a distribution must be subject to tax under I.R.C. § 301, including by application of I.R.C. § 305. *See* I.R.C. §§ 312(d)(1)(B), 316. Distributions in lieu of money generally are not taxable under I.R.C. § 305. *See* I.R.C. § 305(b)(1). The IRS generally requires at least 20 percent of a purging dividend to be in cash for it to not be in lieu of money. *See* Amy S. Elliott, *IRS May Need to Cut Back on Private Letter Rulings, Official Says*, 133 TAX NOTES 514 (Oct. 31, 2011) (quoting IRS Associate Chief Counsel Bill Alexander on this issue as stating, "The private letter ruling policy is going to be 20.").

effectively prevents pre-REIT earnings and profits from escaping or deferring the second level, i.e., shareholder-level, of tax. Therefore, if the spinoff results in the REIT gaining any of the corporation's earnings and profits, the REIT must distribute those earnings and profits to its shareholders before the end of its first taxable year.[93] Shareholders must pay tax on such distributions the same way they would pay tax on them if the corporation had distributed them.[94] This rule ensures that earnings and profits that accrued prior to a REIT spinoff are subject to double taxation—the tax the corporation paid prior to the spinoff and the tax the shareholders pay when the REIT distributes them after the spinoff. REITs often may have insufficient cash to cover the purging dividend, so most purging dividends consist of REIT stock and cash.[95]

2. *Built-In Gains Tax*

A built-in gains tax applies to any built-in gain that carries over to a REIT with assets that are part of a REIT spinoff.[96] The built-in gains tax ensures that gain that was inherent in assets at the time of the REIT spinoff will be subject to the entity-level tax if recognized by the REIT. The built-in gains tax provides that if the REIT sells built-in-gain property within ten years after a REIT spinoff, the highest corporate tax rate will apply to any portion of the built-in gain.[97] To illustrate, recall that Op Corp owns real estate that has an adjusted basis of $3.3 billion and fair market value of $6 billion on the date it spins off that real estate to a newly formed REIT. The built-in gain on those assets is the $2.7 billion difference between the $6 billion fair market value and the $3.3 billion adjusted basis.[98] If the REIT sells the assets one year after the spinoff for $5.8 billion at a time when the adjusted basis is $2.3 billion, the REIT would recognize $3.5 billion of gain,[99] and the built-in gains tax would

93. *See* I.R.C. § 857(a)(2)(B); Reg. §§ 1.337(d)–7(b)(4), 1.857-11.

94. REIT dividends from corporate earnings and profit can qualify for favorable tax rates if they represent previously taxed income. *See* I.R.C. §§ 1(h); 857(c)(2)(B)(iii).

95. *See* P.L.R. 2015-03-010 (July 9, 2014) (ruling in favor of a tax-free REIT conversion that would include a cash dividend equal 20 percent or more of the total distribution); P.L.R. 2013–37–007 (Sept. 28, 2012) (ruling in favor of a tax-free REIT spinoff that would include a purging dividend, at least 80 percent of which could consist of stock); Nugent, *Passive REITs*, *supra* note 72; Ponda, *How Much Gain*, *supra* note 92.

96. *See* Reg. § 1.337(d)–7(a)(1) (applying the rules in I.R.C. § 1374 to the built-in gain resulting from a REIT conversion of spinoff).

97. *See* I.R.C. § 1374; Reg. § 1.337(d)–7. The time period has varied from five to seven years from 2009 to 2014. *See* I.R.C. § 1374(d)(7). If Congress makes no further changes, the period will revert to ten years for 2015.

98. *See* I.R.C. § 1374(d).

99. *See* I.R.C. § 1001(a).

apply to the $2.7 billion of built-in gain that existed at the time of the spinoff.[100] Assuming the highest corporate tax rate at the time of the disposition is 35 percent, the REIT would owe $945 million of tax on the built-in gain.[101] The other $800 million of gain would not be subject to the built-in gains tax. To reflect the effect of an equivalent tax at the corporate level, only $2.555 billion ($3.5 billion of gain net of the $945 million of tax paid by the REIT) would be taxable to the REIT shareholders upon distribution.[102] The result of this rule is that $2.7 billion of built-in gain is subject to double tax, and the $800 million of gain realized by the REIT following the spinoff is only subject to tax at the REIT shareholder level.

This example demonstrates that even though a corporation may spinoff real estate assets tax free, any gains built into the spun off assets will be subject to the highest corporate tax rate if the REIT sells them within ten years after the spinoff. This rule prevents corporations from using the spinoff rules to syphon pre-spinoff income out of the corporation to avoid the corporate double tax. This and the purging rules therefore allow a corporation to spin-off real estate assets tax free into a REIT, but they do not allow the REIT to retain carry-over earnings and profits or to take pre-spinoff gain out of the corporation tax free. Thus, the rules only allow corporations to change the tax treatment of future real estate income, but not to alter the tax treatment of pre-spinoff earnings and profits or built-in gain.

The discussion to this point explains how corporations spin off real estate assets tax free, and how purging dividends and the built-in gains tax help ensure that income attributable to the pre-spinoff corporation is subject to double tax. The tax-revenue effect of the spinoff therefore depends upon the post-spinoff performance of the corporation and the REIT (i.e., the operational effect of the REIT spinoff) and any stock price fluctuation or stock sell off caused by the spinoff (i.e., the transactional effect of the REIT spinoff).

B. *Operational Tax-Revenue Effect of a REIT Spinoff*

To compute the operational effect of a REIT spinoff, the analysis compares how the income from the property would be taxed without the spinoff and how it would be taxed with the spinoff. The analysis also requires assumptions regarding no fewer than six variables that influence the tax-revenue effect of the spinoff. Those six variables, which can include sub-parts, are: (1) the corporate tax rate, (2) the corporate shareholder tax rate, (3) the REIT shareholder tax rate, (4) the extent of corporate-tax-base erosion, (5) the

100. *See* I.R.C. § 1374(b), (d).

101. *See* Reg. § 1.337(d)–7(b)(4). $2.7 billion × 35%.

102. *See* Treas. Reg. § 1.337(d)-7(b)(3)(ii). If the gain is a long-term capital gain, it should flow through to the shareholders as long-term capital gain. *See supra* note 42.

corporation's dividend-payout ratio, and (6) shareholder composition of both the corporation and the REIT. The analysis begins by considering the tax-revenue effect of a REIT spinoff with a few active variables and grows in complexity by incorporating more active variables as the analysis progresses. The analysis begins by assuming that Op Corp's tax rate is 35 percent, the tax rate of Op Corp's shareholders is 23.8 percent, and the tax rate of REIT shareholders is 43.4 percent.[103] It adopts other facts of the Op Corp hypothetical, assuming that the REIT spinoff reduces Op Corp's taxable income from $484 million to $350 million, eroding the corporate tax base by $134 million.[104] At first, it also assumes a 65 percent dividend-payout ratio (i.e., 100 percent of after-tax taxable income[105]) with no tax-exempt ownership.

These assumptions reflect the conventional analysis of the tax-effect of corporate taxation and REIT spinoffs (the conventional analysis[106]). Later, the analysis assumes a 25 percent dividend payout ratio as part of a dynamic analysis, which shows a counterintuitive increase in tax-revenue.[107] The dynamic analysis then considers how tax-exempt stock ownership can cause the tax-revenue effect of a REIT spinoff to be negative even if the corporation's dividend-payout ratio is fairly low. After that, it considers the full composition of shareholders. Finally, the analysis composes formulas that prove that corporate-tax-base erosion does not determine whether the tax-revenue effect of a REIT spinoff will be positive or negative and that other facts have the most significant influence on the tax-revenue effect of a REIT spinoff.

1. *Conventional Analysis of Effect of a REIT Spinoff*

Intuition suggests that REIT spinoffs will reduce tax revenue because they erode the corporate tax base. This intuitive thought derives from assumptions that apply to the conventional analysis. The conventional analysis of the tax-revenue effect of a REIT spinoff assumes that the corporation distributes all of its after-tax taxable income because that assumption currently

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103. *See supra* text accompanying notes 48–54.

104. *See supra* text accompanying notes 82–86.

105. If the corporation pays tax at 35 percent, its after-tax taxable income is 65 percent of its taxable income (1 – 0.35).

106. The assumption that corporations distribute all of their after-tax taxable income is common in many analyses and illustrations. *See, e.g.*, BRADLEY T. BORDEN & ROBERT J. RHEE, 1 LIMITED LIABILITY ENTITIES: A STATE-BY-STATE GUIDE TO LLCS, LPS AND LLPS 16.1[1] (2014); Cauble, *Publicly Traded*, *supra* note 32; Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517, 524–25 (2009).

107. *See infra* Part III.B.2.

accounts for the double taxation of corporate income.[108] Even though that intuitive assumption is generally inaccurate,[109] this analysis adopts that assumption as a starting point to illustrate how a conventional analysis supports intuition.

An orderly analysis considers the tax-revenue and other effects of REIT spinoffs at three levels. First, the analysis considers how a REIT spinoff can erode the corporate tax base and reduce corporate tax liability. Second, it considers how a REIT spinoff can affect shareholder liability, assuming the shareholders are U.S. individuals, and the after-tax cash of shareholders. This part of the analysis considers only the corporate shareholders without the spinoff and considers both the corporate and the REIT shareholders with the spinoff. Third, the analysis considers the overall effect of the REIT spinoff by aggregating the corporate-level and shareholder-level effects.

The analysis relies upon the Op Corp hypothetical, and it computes the tax-revenue effect of a spinoff by comparing what the tax results would be absent the spinoff to what the results would be with the spinoff. Recall that absent the spinoff, Op Corp would have $484 million of taxable income, and would pay $169 million of tax on that income.[110] Assuming Op Corp's dividend-payout ratio is 65 percent of its taxable income, it would distribute about $314 million to its shareholders.[111] If the $314 million distribution to the shareholders is qualified dividend income, the tax on the dividend using the 23.8 percent rate would be about $75 million.[112] After paying that tax, the

108. Corporate income would be subject to the shareholder-level tax at any time the corporation distributes it to shareholders. Thus, even if the corporation delayed distributing taxable income for some years, it would still be subject to shareholder-level tax upon distribution. The time value of money would, of course, make the tax revenue less valuable. A perfectly accurate analysis of the tax effect of REIT spinoffs should perhaps consider how delayed corporate distributions affect tax revenue, but with many corporations having perpetual existence, corporations can delay distributing taxable income indefinitely. This Article therefore assumes that the corporation distributes all after-tax taxable income currently, or distributes some smaller amount currently and retains the undistributed amount indefinitely. This assumption does not provide for a perfect reflection of the tax-revenue effect of the REIT spinoff, but this assumption is offset at least in part by the assumption that dividends paid to tax-exempt retirement funds are subject to tax, even though that income is taxed when distributed to the funds' beneficiaries. *See* I.R.C. §§ 61(a)(11), 402(a). The computation of the present values of the tax on undistributed corporate taxable income and the tax on undistributed retirement-fund income are beyond the scope of this Article.

109. *See supra* note 45.

110. *See supra* text accompanying note 77.

111. $484 million × 0.65. Rounding in various parts of the analysis may cause dollar figures to vary by one or two digits.

112. Appendix B presents detailed calculations of these results.

shareholders would have about $239 million.[113] The total tax paid by Op Corp and the shareholders would be about $244 million.[114] After paying interest and tax,[115] the aggregate remaining cash would be $628 million.[116] Compare those results to the results with the spinoff, at both the corporate and shareholder level.

a. Corporate-Level Effect

With the spinoff, Op Corp would have taxable income of $350 million and pay $123 million in income tax at 35 percent.[117] The REIT spinoff therefore erodes the corporate tax base by $134 million.[118] That $134 million is 28 percent of the corporate taxable income without the spinoff. With the spinoff, Op Corp pays $46 million less of tax,[119] so its tax liability decreases 27 percent. If the analysis stopped here, it would appear to support intuition, the effect of the REIT spinoff would appear to be significant, and it would justify the public concern about REIT spinoffs, but the shareholder-level effect offsets much of what happens at the corporate level.

b. Shareholder-Level Effect

With the spinoff, Op Corp would have about $227 million of after-tax taxable income to distribute to its shareholders.[120] At the 23.8 percent rate the shareholders would pay about $54 million of tax on the $227 million distribution, and after paying that tax, the Op Corp shareholders would have about $173 million.[121] The REIT shareholders would also receive a dividend. After deducting the interest and depreciation, the REIT would have about $134 million of taxable income.[122] Assuming the REIT distributes all $134 million to the REIT shareholders,[123] it will owe no income tax, but at 43.4 percent, the

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113. $314 million distribution – $75 million of Op Corp shareholder tax.

114. $169 million corporate tax + $75 million Op Corp shareholder tax.

115. The depreciation deduction does not represent a present cash outlay, *see* I.R.C. § 263(a) (prohibiting deductions for costs of real estate); I.R.C. §167(a) (allowing a deduction for depreciation), so it would not affect the aggregate after-tax amount.

116. $1 billion total revenue from the property – $128 million of interest payments – $169 million corporate tax liability – $75 million shareholder liability.

117. *See supra* text accompanying notes 84.

118. $484 million without the spinoff – $350 million with the spinoff.

119. $169 million without the spinoff – $123 million with the spinoff.

120. $350 million taxable income – $123 million tax paid.

121. $228 million Op Corp dividend – $54 million Op Corp shareholder tax.

122. *See supra* text accompanying notes 84.

123. Publicly-traded REITs typically distribute more than 100 percent of their taxable income. *See* Walter I. Boudry, *An Examination of REIT Dividend Payout*

REIT shareholders would pay about $58 million of tax on the REIT dividend.[124] That amount subtracted from the $134 million REIT dividend would leave the REIT shareholders with about $76 million after tax from the REIT. The total distribution received by the shareholders would be $361 million,[125] their total tax would be $112 million,[126] and their after-tax amount would be $249 million.[127]

These numbers compared with the numbers from the no-spinoff results show that the spinoff increases shareholder tax liability and their after-tax amount. The REIT spinoff increases shareholder tax liability by $37 million,[128] a 49 percent increase. The REIT spinoff also increases the shareholder after-tax amount by $9 million,[129] a 3.75 percent, increase. Thus, the REIT spinoff increases shareholder tax liability significantly, but it also increases the shareholders' after-tax amount.

c. *Overall Effect*

The shareholder-level tax-revenue effect offsets the apparent corporate-level tax benefit to generate a result that is much different than could be expected by focusing solely on the corporate-level effect of the spinoff. The total tax liability without the spinoff would be $244 million,[130] and with the spinoff it would be about $235 million.[131] Thus, the REIT spinoff causes aggregate tax liability to decrease by $9 million,[132] a 3.69 percent decrease.

Policy, 39 REAL EST. ECON. 601, 612–13 (2011) [hereinafter Boudry, *Payout Policy*] (showing that REIT distributions average about 120 percent of REIT taxable income). Thus, this assumption is reasonable.

124. *See supra* text accompanying notes 53 (describing the tax rate generally applicable to REIT dividends).

125. $227 million Op Corp dividend + $134 million REIT dividend.

126. $54 million Op Corp shareholder tax + $58 million REIT shareholder tax.

127. $361 million total dividend – $112 million total shareholder tax. The hypotheticals in this Article assume that REITs make cash distributions instead of offering a dividend reinvestment program (DRIP), which allow REIT shareholders to receive additional shares in the REIT rather than cash dividends. The IRS has, however, blessed DRIPs and permit REITs to take the dividend paid deduction with respect to the distributed shares. *See* Rev. Rul. 83–117, 1983–2 C.B. 98. Surely some shareholders elect to participate in REIT DRIPs, so they would still remain liable for any tax owed on the dividend, and their after-tax amount would not be denominated in cash received.

128. $112 million tax with the spinoff – $75 million tax without the spinoff.

129. $240 million without the spinoff – $249 million with the spinoff.

130. $169 million corporate tax + $75 million shareholder tax.

131. $123 million Op Corp tax + $54 million Op Corp shareholder tax + $58 million REIT shareholder tax.

132. $244 million without the spinoff – $235 million with the spinoff.

Notice that the $9 million decrease in aggregate tax liability exactly equals the $9 million increase in the after-tax amount to the shareholders. The aggregate after-tax amount with the spinoff would be $637 million.[133] That amount is also $9 million greater than the $628 million aggregate after-tax amount with no spinoff. Thus, the analysis suggests that the shareholders directly reap the benefit of the reduced tax liability. The results using these assumptions may not be unexpected, but they could surprise some observers. The spinoff intuitively erodes the corporate tax base and reduces corporate tax liability.[134] The aspect of the results that may surprise many observers is that the REIT spinoff increases the shareholders' total tax liability. As percentages, the effects appear to be more pronounced. The $134 million corporate-tax-base erosion is 28 percent of the corporate tax base absent the spinoff, and the $46 million decrease in corporate tax liability is a 27 percent decrease. The shareholders' tax liability increases by about 49 percent with the spinoff, but the REIT distribution requirement ensures that their after-tax amount also increases. The overall tax liability decreases by 3.69 percent, which appears to be modest, but is impressive because it results from a mere change in ownership of the real estate. Table 2 summarizes the comparison of non-spinoff results and spinoff results. The results of the conventional analysis support intuition, but they change as the assumptions used in the example change.

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133. $1 billion total revenue from the property – $128 million of interest payments – $123 million Op Corp tax – $112 million Op Corp shareholder liability.

134. $169 million – $123 million.

Table 2: Tax-Revenue Effect of REIT Spinoff with Conventional Analysis (65% dividend-payout ratio)

	No Spinoff	
	Op Corp	REIT
Gross Income	$1,000,000,000	--
Interest	($ 128,000,000)	--
Depreciation	($ 388,000,000)	--
Rent	--	--
Corp. Taxable Income	$484,000,000	
Corp. Tax Liability	$169,000,000	--
Distribution	$314,000,000	--
Total Shareholder Tax Liability	$ 75,000,000	
Total After-Tax to Shareholders	$240,000,000	
Total Tax Liability	$244,000,000	
Aggregate After-Tax Amount	$628,000,000	

	With Spinoff	
	Op Corp	REIT
Gross Income	$1,000,000,000	$ 650,000,000
Interest	--	($ 128,000,000)
Depreciation	--	($ 388,000,000)
Rent	($650,000,000)	--
Corp. Taxable Income	$350,000,000	$134,000,000
Corp. Tax Liability	$123,000,000	$0
Distribution	$227,000,000	$134,000,000
Shareholder Tax Liability	$ 54,000,000	$ 58,000,000
Total Shareholder Tax Liability	$112,000,000	
Total After-Tax to Shareholders	$249,000,000	
Total Tax Liability	$235,000,000	
Aggregate After-Tax Amount	$637,000,000	

Table 2: Tax-Revenue Effect of REIT Spinoff with Conventional Analysis (65% dividend-payout ratio)		
Net Effects of REIT Spinoff		
Corporate-Level Effect	Effect on Corporate Tax Base	-$134,000,000 (-28%)
	Effect on Corporate Tax Revenue	-$46,000,000 (-27%)
Shareholder-Level Effect	Effect on Shareholder Tax Liability	$37,000,000 (49%)
	Effect on Shareholder After-Tax Cash	$9,000,000 (3.75%)
Overall Effect	Effect on Aggregate Tax Revenue	-$9,000,000 (-3.69%)
	Effect on Aggregate After-Tax Amount	$9,000,000 (1.4%)

With the conventional analysis, the $244 million total tax liability as a percentage of the $484 taxable income is 50.47 percent without the restructuring, and the $234 million total tax liability with the spinoff is 48.51 percent of the total taxable income with the spinoff.[135] That is a 1.96 percentage point reduction. Thus, intuitively, the spinoff reduces the effective tax rate of income attributable to spinoff assets. The 1.96 point decrease varies from the 6.67 percentage point differences computed above, which compared the corporate tax treatment to REIT taxation, but did not consider the effect of a spinoff.[136] The difference between the 1.96 and 6.67 is attributed to the corporation being unable to purge itself of all income from the real estate assets as a result of the REIT spinoff. For the lease from the REIT to Op Corp to have economic substance, it must be arms-length and therefore profitable to Op Corp.[137] Therefore, a REIT spinoff only removes the fair market rental value of the real estate assets from the corporation. The operating profit from those

135. This 48.51 percent differs from the 43.4 percent effective rate of REIT taxation computed above, *see supra* note 53, because this analysis considers 100 percent of the income from the real estate, which includes income from the real estate recognized by Op Corp. The earlier analysis of the REIT's effective tax rate assumed the REIT recognized all of the income from the real estate.

136. *See supra* text accompanying note 54.

137. *See* I.R.C. § 7701(o) (requiring the transaction to have a substantial non-tax purpose to satisfy the economic substance doctrine); William Joel Kolarik II, et al., *The Economic Substance Doctrine in Federal and State Taxation*, 67 TAX LAW. 715, 746–60 (2014); Amanda L. Yoder, Note, *One Prong, Two Prong, Many Prongs: A Look into the Economic Substance Doctrine*, 75 MO. L. REV. 1409, 1416–26 (2010).

assets remains with the corporation.[138] Thus, the spinoff under these assumptions improves the tax situation of the corporation and shareholders, but the improvement is not spectacular, and the tax-revenue effect is modest. Contrast those results with the counterintuitive results obtained by using a dynamic analysis.

2. *Dynamic Analysis of Effect of a REIT Spinoff*

A dynamic analysis assumes variables that more closely reflect reality. To begin with, assume Op Corp's dividend-payout ratio is 25 percent of its taxable income, in line with the estimated current average,[139] but all other assumptions used thus far remain the same.[140] Changing this one assumption to reflect reality does not change the corporate-level effect, but it causes two counterintuitive results—(1) the REIT spinoff generates more tax revenue for the government; and (2) the after-tax results for the shareholders increase. Without the REIT spinoff, Op Corp's taxable income would be $484 million,[141] and its tax liability would be $169 million.[142] It would only distribute 25 percent of the $484 million taxable income, so the distribution would be $121 million. At the 23.8 percent rate, the Op Corp shareholders would pay about $29 million of tax on the distribution. After paying the tax, the shareholders would have about $92 million.[143] The total tax paid by Op Corp and its shareholders would be $198 million.[144] After the interest and tax payment, the aggregate after-tax amount would be $674 million.[145]

Notice how the lower dividend-payout ratio alters the tax treatment of the real estate. The lower dividend-payout ratio results in $46 million less of

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138. The IRS could challenge the value Op Corp and REIT assigned to the lease and rental payments, but the terms of the lease will most likely reflect fair market value. Because Op Corp and REIT are both publicly traded, the stock price of both entities will depend upon the terms of the lease. To ensure the appropriate value of the stock of each entity, the mergers of Op Corp and REIT must ensure the lease reflects market value. *See* Lee A. Sheppard, *Gambling on REIT Status*, 143 TAX NOTES 1463, 1465–67 (June 30, 2014) (discussing issues related to valuation of the lease between a REITs and an operating company).

139. *See supra* text accompanying notes 45.

140. *See supra* text accompanying notes 103–106.

141. *See supra* text accompanying note 76.

142. *See supra* text accompanying note 77.

143. $121 million distribution – $29 million of tax.

144. $169 million Op Corp tax + $29 million Op Corp shareholder tax.

145. $1 billion total revenue from the property – $128 million of interest payment – $169 million corporate tax – $29 million Op Corp shareholder tax.

total tax,[146] and it provides $46 million more in aggregate after-tax money.[147] Nonetheless, without the spinoff, the shareholders appear to come out significantly worse off with the lower dividend-payout ratio. Instead of having $239 million after-tax money with the 65 percent dividend-payout ratio, the shareholders end up with $92 million after tax. Shareholders who prefer to directly control earnings would prefer the higher dividend-payout ratio. A REIT spinoff significantly improves the after-tax situation of shareholders, even if (or particularly if) the corporation has a lower dividend-payout ratio.

a. *Corporate-Level Effect*

A corporation's dividend payout ratio should not affect the corporate-level tax treatment of income from the real estate.[148] With a 25 percent dividend-payout ratio and a REIT spinoff, Op Corp's taxable income would be $350 million,[149] and its tax liability would be $123 million.[150] With the lower dividend-payout ratio, the REIT spinoff causes the same $134 million corporate-tax-base erosion and $46 million decrease in corporate tax liability. A change in dividend-payout ratio therefore does not affect the corporate-level result of a REIT spinoff. Instead, the change occurs at the shareholder level.

b. *Shareholder-Level Effect*

With the spinoff and lower divided-payout ratio, Op Corp would distribute only about $88 million to its shareholders.[151] At the 23.8 percent rate, the Op Corp shareholders would pay about $21 million of tax on that $88 million distribution. After paying that tax, the Op Corp shareholders would have $67 million.[152] The REIT would have and distribute the same $134 million of taxable income to its shareholders,[153] so it would pay no income tax.[154] At the 43.4 percent rate, the REIT shareholders would pay the same $58

146. $244 million total tax with a 65 percent dividend-payout ratio – $198 million total tax with a 25 percent dividend-payout ratio.

147. $674 aggregate after-tax amount with a 25 percent dividend-payout ratio – $628 million aggregate after-tax amount with a 65 percent dividend-payout ratio.

148. One possible effect of a change in dividend-payout ratio is a chance that the IRS would attempt to impose an accumulated earnings tax on the corporation, but corporations can generally plan to avoid that tax. *See supra* note 50. This analysis assumes Op Corp will not be subject to the accumulated earnings tax.

149. *See supra* text accompanying note 82.

150. *See supra* text accompanying note 83.

151. $350 million taxable income × 25%.

152. $88 million Op Corp dividend – $21 million Op Corp shareholder tax.

153. *See supra* text accompanying note 84.

154. *See supra* text accompanying notes 41–42.

million of tax on the REIT distribution that they paid above.[155] After paying that tax, the REIT shareholders would have $76 million.[156] The total dividend received by the shareholders under the current assumptions would be $222 million,[157] the shareholders' total tax liability would be $79 million,[158] and the after-tax amount to the shareholders would be $143 million.[159]

These results compared to the no-spinoff results show that the spinoff substantially increases the shareholder tax liability but increases the shareholder after-tax amount more. Compared to the $29 million that the Op Corp shareholders paid with no REIT spinoff, the $79 million tax is a $50 million increase, so the spinoff increases the shareholder tax liability by 172 percent. The REIT spinoff also increases the shareholder after-tax amount from $92 million without the spinoff to $143 million with the spinoff, for a $51 million, or 55 percent, increase. Shareholders may prefer the spinoff results because they increase their after-tax amount considerably, even though the spinoff also increases their tax liability.

c. *Overall Effect*

The lower dividend-payout ratio magnifies the offset effect that the shareholder liability has on corporate-tax-base erosion and the overall effect of the REIT spinoff. The total tax liability without the spinoff and with the lower dividend-payout ratio would be $198 million,[160] and with the spinoff it would be $202 million.[161] Thus, the REIT spinoff counterintuitively causes the total tax liability to increase. The amount of the increase is $4 million, which is 2 percent of the total liability without the spinoff. The aggregate after-tax amount with the spinoff is $670 million.[162] That amount is $4 million less than the $674 million aggregate after-tax amount without the spinoff.[163] Thus, all of the benefit of the decreased tax liability goes directly to the shareholders, but they also benefit from the increased dividends that result from the REIT distribution requirement, and they end up with $51 million more with the REIT spinoff.

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155. *See supra* text accompanying notes 124.
156. $134 million REIT dividend – $58 million REIT shareholder tax.
157. $88 million Op Corp dividend + $134 million REIT dividend.
158. $21 million Op Corp shareholder liability + $58 million REIT shareholder liability.
159. $222 million total dividend – $79 million total shareholder tax liability.
160. $169 million Op Corp tax liability + $29 million shareholder liability.
161. $123 million Op Corp tax + $79 million shareholder tax.
162. $1 billion total revenue from the property – $128 million of interest paid – $123 million Op Corp tax – $79 million shareholder tax.
163. *See supra* text accompanying note 145.

Table 3: Tax-Revenue Effect of REIT Spinoff with Dynamic Analysis (25% dividend-payout ratio)

	No Spinoff	
	Op Corp	REIT
Corp. Taxable Income	$484,000,000	--
Corp. Tax Liability	$169,000,000	--
Distribution	$121,000,000	--
Total Shareholder Tax Liability	$29,000,000	
Total After-Tax to Shareholders	$92,000,000	
Total Tax Liability	$198,000,000	
Aggregate After-Tax Amount	$802,000,000	

	With Spinoff	
	Op Corp	REIT
Corp. Taxable Income	$350,000,000	$134,000,000
Corp. Tax Liability	$123,000,000	$0
Distribution	$ 88,000,000	$134,000,000
Shareholder Tax Liability	$ 21,000,000	$ 58,000,000
Total Shareholder Tax Liability	$ 79,000,000	
Total After-Tax to Shareholders	$143,000,000	
Total Tax Liability	$202,000,000	
Aggregate After-Tax Amount	$798,000,000	

Net Effects of REIT Spinoff		
Corporate-Level Effect	Effect on Corporate Tax Base	-$ 134,000,000 (-28%)
	Effect on Corporate Tax Revenue	-$ 46,000,000 (-27%)
Shareholder-Level Effect	Effect on Shareholder Tax Liability	$50,000,000 (172%)
	Effect on Shareholder After-Tax Cash	$50,000,000 (54%)
Overall Effect	Effect on Aggregate Tax Revenue	$ 4,000,000 (2%)
	Effect on Aggregate After-Tax Amount	-$ 4,000,000 (-0.5%)

The results from changing the assumption about Op Corp's dividend-payout ratio are counterintuitive and will surprise many observers. Under these assumptions, the spinoff still reduces the corporate tax liability by the same \$46 million because the spinoff erodes the corporate tax base by the same amount. But with 25 percent dividend-payout ratio, the REIT spinoff significantly increases the shareholder liability from \$29 million to \$79 million, a \$50 million surge, but it also puts \$51 million more into the shareholders' hands after they pay that extra tax. The net effect is that the REIT spinoff increases the total tax liability by about \$4 million, but it also causes the shareholders to have \$51 million more after tax. The increased tax liability and additional after-tax cash to the shareholders resulting from a REIT spinoff are counterintuitive, but the results reflect the effect of the REIT distribution requirement. The REIT dividend-distribution requirement causes the REIT to distribute income that Op Corp would not have distributed otherwise. That increased distribution outpaces the increased tax the shareholders pay, so they net considerably more with the REIT spinoff. Table 3 summarizes the results that are obtained under a dynamic analysis that assumes Op Corp distributes just 25 percent of its taxable income.

Under the assumptions that cause this result, the \$198 million of tax liability with no spinoff is 40.91 percent of the \$484 million of taxable income. By contrast, the \$202 million of total tax liability with the spinoff is 41.74 percent of the \$484 million of total taxable income. Thus, if the corporation only distributes 25 percent of its taxable income, the REIT distribution requirement and the REIT shareholders' higher tax rate results in a 0.83 percentage point increase in the effective rate of the real estate's income and a 2 percent increase in tax revenues. This analysis suggests that REIT spinoffs may erode the corporate tax base, but they also could increase government tax revenue and provide a better after-tax result for shareholders. Thus, even though a spinoff could have adverse tax consequences overall to the corporation and shareholders, they may nonetheless approve the spinoff for various reasons.[164] Nonetheless, other assumptions must factor into the analysis. In particular, shareholder composition can influence the tax-revenue effect of a REIT spinoff.

3. *Influence of Shareholder Composition*

The analysis to this point has assumed that corporate and REIT shareholders are all individuals subject to tax rates dependent upon the type of stock they hold. In reality, the composition of corporate and REIT shareholders appears to vary somewhat, and different classes of shareholders are subject to different tax rates or are exempt from tax altogether. Changing the assumption about the composition of shareholders changes the tax-revenue effect of a

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164. *See infra* text accompanying notes 270–276.

REIT spinoff. Of particular interest is the percentage ownership of stock by tax-exempt and foreign investors.[165]

Institutional investors, such as retirement funds and endowments, are tax exempt,[166] so they generally do not pay tax on dividends they receive from corporations and REITs.[167] Other institutional investors, such as mutual funds and hedge funds, generally are not subject to tax, but their taxable income flows through to their members who must pay tax on dividends received by such funds.[168] Consequently, only some dividends paid to retirement funds and endowments and other such institutional investors are exempt from tax at the shareholder level. The tax treatment of foreign investors may also differ from the tax treatment of individuals. Therefore, shareholder composition is an important part of the dynamic analysis of the tax-revenue effect of REIT taxation. The analysis must determine both the percentage ownership of each class of shareholder and the tax rate that applies to the shareholder.

Identifying the level of tax-exempt ownership of corporations and REITs is a challenge. A study published in 1998 indicates that since 1994,

165. This Article uses the term "foreign investor" to refer to a person that is either a nonresident alien individual as defined in I.R.C. § 7701(b)(1)(B) or a foreign corporation as defined in I.R.C. § 7701(a)(5).

166. *See* I.R.C. § 501(a). If the tax-exempt entity is a retirement fund, the income will ultimately be taxed upon distribution to beneficiaries, *see* section 402(a), but the passage of time until that distribution and the time value of money could make the present value of that future tax payment negligible. Consequently, this Article assumes that dividends paid to tax-exempt investors are not taxed.

167. *See* I.R.C. § 512(b)(1) (ensuring that dividends are not unrelated business taxable income).

168. Mutual funds are regulated investment companies (RICs) and, like REITs, are not subject to an entity-level tax. *See* I.R.C. § 852; Samuel D. Brunson, *The Taxation of RICs: Replicating Portfolio Investment or Eliminating Double Tax*, 19 STANFORD J. L. BUS & FIN. (forthcoming 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2486762 (recounting the history and purpose of RICs, criticizing the distribution requirement, and recommending changes that would preserve the single level of tax, do away with the distribution requirement, and provide liquidity to RIC investors) Stephen E. Fisher, *RICs and the Retail Investor: A Marriage of Convenience or Necessity?*, 66 TAX LAW. 331 (2013) (discussing tax and legal aspects of RICs and other flowthrough and conduit entities). In fact, REIT taxation is modeled after the RIC regime. *See* H.R. REP. No. 84-2842, at 3 (1956) ("[The proposed legislation] provides substantially the same tax treatment for real estate investment trusts as present law provides for regulated investment companies."); Borden, *Reforming REIT Taxation*, *supra* note 15. Nonetheless, their income flows through to their shareholders who generally must pay tax on the distributions. *See* I.R.C. §§ 61(a)(7), 301(c). Hedge funds are forms of partnerships, *see* Heather M. Field, *The Real Problem with Carried Interests*, 65 HASTINGS L.J. 405, 412 ("[H]edge funds are generally operated by entities that are treated as partnerships for federal income tax purposes."), so their income flows through to the hedge funds partners. *See supra* notes 55–59.

institutional ownership of REIT stock could have been greater than institutional ownership of non-REIT stock.[169] Other studies estimate that the proportionate institutional ownership of REIT stock remains very comparable to the proportionate institutional ownership of non-REIT stock today.[170] Based upon the more recent studies, institutions appear to own somewhere between 64 percent and 67 percent of REIT and non-REIT stock.[171] Other reports appear to draw similar conclusions.[172] Even though reports do not specifically identify what percent of institutional investors are tax exempt, one report provides that pension and government retirements funds own 17 percent of the domestic equity market, with another 8 percent possibly being tax exempt.[173] That report suggests that 25 percent is not an unreasonable estimate of tax-exempt ownership of stock,[174] so this analysis adopts 25 percent as the percentage for tax-exempt ownership of both corporate and REIT stock. Even if the assumption is off by more than a nominal amount, the value helps illustrate how tax-exempt ownership can influence the tax-revenue effect of a REIT spinoff. Distributions to tax-exempt shareholders are not subject to income tax, so the tax rate for tax-exempt shareholders is zero percent.

Apparently, foreign-investor preference for REITs differs slightly from foreign-investor preference for corporations. One report provides that foreign investors held 13 percent of the outstanding corporate stock in 2011.[175] A comparison of foreign investment in REITs to REIT market capitalization provides an estimate of foreign ownership of REIT stock. A report by the

169. *See* Su Han Chan, et al., *Institutional Investment in REITs: Evidence and Implications*, 16 J. REAL EST. RESEARCH 357, 363–64 (1998) (showing that the average institutional investment in REIT stock increased from 5.61 percent in 1984 to 31.42 percent in 1995, while the average institutional investment in stock of comparable non-REIT corporations increased from 9.08 percent in 1984 to 25.05 percent in 1995).

170. *See* Blume & Keim, *Trends and Relationships*, *supra* note 46 (estimating that institutions own 67 percent of all stock in 2010, which would include ownership of REIT stock); Feng et al., *Overview*, *supra* note 28, at 312 (estimating institutional ownership of REIT stock had risen to 64 percent in 2009).

171. *See* Blume & Keim, *Trends and Relationships*, *supra* note 46; Feng et al., *Overview*, *supra* note 28. *See id.*

172. *See, e.g.*, David J. Kostin, et al., *2031 US Equity Outlook: Selectivity Seeking Growth*, 17 (Nov. 28, 2012) [hereinafter Kostin et al., *Selectively Seeking*], http://www.mauldineconomics.com/images/uploads/overmyshoulder/Goldman_Sachs_-_US_Equity_Outlook.pdf (reporting that households held 35 percent of the domestic equity market in 2011, the balance being held by institutional and foreign investors).

173. *See id.* at 17.

174. The other types of institutional investors include mutual funds, hedge funds, and ETFs, which may not be subject to tax, but which are flow-through partnerships or RIC conduits. *See supra* note 168.

175. *See* Kostin et al., *Selectively Seeking*, *supra* note 172, at 17.

Federal Reserve and Treasury estimates that foreign investors held $140.021 billion of U.S. REIT stock in 2013.[176] At the end of 2013, total REIT market capitalization was $670.334 billion,[177] so foreign investors appeared to hold approximately 21 percent of outstanding REIT stock in 2013.

Assuming the dividends are not effectively connected to the investors' conduct of a trade or business in the United States, the tax rate applicable to dividends paid to foreign investors can range from 5 percent to 30 percent, depending upon whether a treaty provides a favorable rate for an investor from a particular country.[178] The current dividend tax rate in the U.S. Model Tax Convention is 15 percent if the foreign investor holds less than 10 percent of the stock of a corporation,[179] so this analysis assumes that dividends paid to foreign investors are taxed at 15 percent.

Funds are another class of shareholder. They appear to hold about 27 percent of corporate stock.[180] Income of funds flows through to members of those funds.[181] Individuals own the remaining 35 percent of corporate stock.[182] Apparently similar information about REIT stock ownership by funds and individuals is not publicly available. The analysis therefore assumes that individuals own the same 35 percent of REIT stock, and funds own 19 percent

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176. *See* DEPARTMENT OF THE TREASURY, FEDERAL RESERVE BANK OF NEW YORK & BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FOREIGN PORTFOLIO HOLDINGS OF U.S. SECURITIES, TABLE A11 at A-55 (Apr. 2014) (providing estimates of June 30, 2013 holdings), http://www.treasury.gov/ticdata/Publish/shla2013r.pdf.

177. *See* Appendix A. The information about foreign investment and REIT market capitalization differ by six months, so the actual percentage held by foreign investors could be a few percentage points different, but the rough estimate is sufficient to illustrate the potential tax-revenue effect of foreign investment in REITs.

178. *See* I.R.C. §§ 871(a)(1)(A), 881(a)(1), 894 (imposing a 30 percent general tax rate on dividends paid to foreign investors); JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C4.07 (2014) (listing the dividend rates under various U.S. treaties ranging from 5 percent to 30 percent); Staffaroni, *Foreign Investors*, *supra* note 20 (explaining the application of the U.S. tax and treaty rules to foreign investors in REITs and RICs).

179. *See* United States Model Income Tax Convention of November 15, 2006, art. 10(2)(b), (3), (4), *reprinted in* 1 TAX TREATIES (CCH) ¶ 209, at 10,553 [hereinafter Model Tax Convention]. *See also* Ameek Ashok Ponda, *Foreign Pension Plans Investing in Shares of a U.S. REIT*, 74 TAX NOTES 1593, 1598–99 (Mar. 24, 1997) (discussing the tax rates on REIT dividends as provided for in various treaties)

180. *See* Kostin et al., *Selectively Seeking*, *supra* note 172 (providing that mutual funds hold 20 percent, hedge funds hold 3 percent, and exchange traded funds hold 4 percent of corporate stock).

181. *See supra* note 168.

182. *See* Kostin et al., *Selectively Seeking*, *supra* note 172.

of REIT stock.[183] Assuming the members of funds are individuals,[184] dividends paid to the funds and individuals would be taxed at individual rates—23.8 percent for corporate dividends and 43.4 percent for REIT dividends.

The percentage ownership and tax rates of the various shareholders provide the basis for determining the total effective tax rate on corporate and REIT dividends. The computation requires multiplying the percentage of stock held by a particular class by the tax rate of that class to determine the effective tax rate of a particular shareholder class. The total effective tax rate is the sum of the effective tax rates of the various classes. Drawing from the assumptions in this analysis, Table 4 shows that the effective tax rate on corporate dividends is 16.71 percent, and the effective tax rate on REIT dividends is 26.59 percent.

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183. The allocation of the remaining REIT stock ownership between individuals and funds is immaterial if fund income flows through to individuals.

184. The members of the funds could, of course, be tax-exempt or foreign investors. If they were foreign investors, the dividend income should flow through and qualify for the favorable dividend rate, assuming the funds are not engaged in a U.S. trade or business. *See* Model Tax Convention, *supra* note 179, at art. 1.6 (providing that tax items of a fiscally transparent entity flow through to members of the entity, if the laws of the relevant country treat the items as flowing through); United States Model Technical Explanation Accompanying The United States Model Income Tax Convention of November 15, 2006, commentary on art. 1(6), p. 5–6, *reprinted* in 1 TAX TREATIES (CCH) ¶ 215, at 10,617 (providing that fiscally transparent entities include partnerships and using the example of interest received by a partnership to illustrate how the income would normally flow through to a foreign investor). If they are tax exempt, the dividend income should not be subject to tax, unless it is unrelated business taxable income. *See supra* note 40. This analysis assumes that the investors are individuals because information about fund composition does not appear to be readily available, and considering multiple tiers of fund ownership would add unwieldy complexity to the analysis.

Table 4: Shareholder Composition			
		Corporation	
	Percentage Held by Class	Applicable Tax Rate	Effective Tax Rate
Individuals	35%	23.8%	8.33%
Tax-Exempts	25%	0%	0%
Foreign	13%	15%	1.95%
Funds	27%	23.8%	6.43%
Total Effective Tax Rate			16.71%
		REIT[185]	
	Percentage Held by Class	Applicable Tax Rate	Effective Tax Rate
Individuals	35%	43.4%	15.19%
Tax-Exempts	25%	0%	0%
Foreign	21%	15%	3.15%
Funds	19%	43.4%	8.25%
Total Effective Tax Rate			26.59%

A complete dynamic analysis must consider how the shareholder composition influences the tax-revenue effect of a REIT spinoff. The following analysis considers the effect of tax-exempt shareholders in depth to illustrate the analysis. Then it summarily analyzes the effect of foreign investment in less detail. Shareholder composition does not affect the tax paid at the corporate level, so a corporation's taxable income is subject to the 35 percent tax rate,[186] regardless of the amount of stock owned by tax-exempt investors. Consequently, the tax-revenue effect of tax-exempt ownership occurs at the corporate-shareholder and the REIT-shareholder level, with respect to corporate taxable income that migrates to the REIT and avoids entity-level taxation.

Assuming tax-exempt institutions own 25 percent of the outstanding stock of a corporation and REIT and individuals own the balance, the tax-exempt ownership would remove 25 percent of the dividends from taxation, leaving only 75 percent of dividends to be taxed. Thus, 25 percent tax-exempt ownership reduces the effective tax rate, under the assumptions in this analysis, on all dividend income to 75 percent of the normal effective dividend tax rate. Consequently, the effective tax rate on all non-REIT qualified dividend income and the capital gains portion of REIT dividends decreases

185. The tax rates for REIT shareholders are those that apply to the ordinary income portion of REIT dividends. *See supra* note 52.

186. *See supra* note 48.

from 23.8 percent to 17.85 percent,[187] and the effective tax rate on the ordinary income portion of all REIT dividends decreases from 43.4 percent to 32.55 percent.[188] Because REIT taxable income is a shareholder-level tax, tax-exempt stock ownership reduces tax on REIT taxable income faster than it reduces tax on corporate taxable income.

The reduction of the effective tax rate on corporate dividends affects only a fraction of the overall tax on corporate taxable income. As shown above, if a corporation distributes 100 percent of its after-tax taxable income, the effective tax rate on that income is 50.47 percent.[189] The portion of that tax paid by corporate shareholders is not more than about 31 percent of the total tax liability paid on the corporate taxable income.[190] Ownership of corporate stock by tax-exempt shareholders only affects that portion of the total tax liability on corporate taxable income. Consequently, tax-exempt ownership of corporate stock can reduce the tax liability on corporate taxable income by no more than one-third of the total that would be paid if no tax-exempt entity held corporate stock. If tax-exempt investors own 25 percent of the stock of a corporation with a 65 percent dividend-payout ratio, their ownership reduces the effective tax rate on taxable income 3.87 percentage points to 46.6 percent.[191] Tax-exempt ownership of 25 percent of the corporate stock thus reduces the overall tax on corporate taxable income by 7.67 percent.[192] If the corporation distributes only 25 percent of its taxable income, the effective tax rate on corporate taxable income would be 40.95 percent, if all of the dividends were subject to shareholder tax.[193] If tax-exempt shareholders own 25 percent of the stock of a corporation with a 25 percent dividend-payout ratio, the effective tax rate would decrease to 39.46 percent.[194] Thus, tax-exempt

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187. 23.8% × 75%. Detailed computations are in Appendix C.

188. 43.4% × 75%.

189. *See supra* text accompanying note 49.

190. If the corporation has $100 of taxable income, the total tax liability will be $50.47. Of that amount, $35 ($100 × 35%) would be from the corporation, and the remaining $15.47 ($65 after-tax distribution × 23.8%) would be from the shareholders. *See supra* text accompanying note 47. The shareholder's $15.47 tax liability is 30.65 percent of the $50.47 total tax.

191. To illustrate, if the corporation has $100 of taxable income, it will pay $35 of tax at 35 percent. Assuming a 25 percent dividend-payout ratio, it will distribute $25, and, because of tax-exempt ownership, 75 percent, or $18.75, will be subject to shareholder tax. At 23.8 percent, the shareholders would pay $4.63 of tax on the $18.75. The total tax on the corporate taxable income would therefore be $39.63 ($35 + $4.63), or 39.63 percent of the corporate taxable income. *See* Appendix C.

192. The math behind the number is 10.36 ÷ 50.47.

193. *See supra* text accompanying note 50.

194. If 25 percent of the shareholders are exempt from tax, 72 percent, or $18.75, of the $25 distribution, will be subject to shareholder tax. At 23.8 percent, the tax liability of the taxable shareholders would be $4.46. Total tax liability, assuming

ownership reduces that effective rate by 1.49 percentage points, or 3.64 percent. Assuming a REIT distributes all of its taxable income, taxable shareholders would normally pay tax on that taxable income at 43.4 percent.[195] If tax-exempt investors own 25 percent of the REIT's stock, only 75 percent of the REIT taxable income would be subject to tax. The effective tax rate on REIT dividends would therefore be 32.55 percent, or 75 percent of 43.4 percent with no tax-exempt ownership. Consider how 25 percent tax-exempt stock ownership alters the tax-revenue effect in the Op Corp example.

Because stock ownership by tax-exempt entities should not affect the amount of tax that Op Corp pays, and the analysis assumes that the corporate-tax-base erosion remains constant, Op Corp's tax liability would be $169 million absent the spinoff and would be $123 million with the spinoff.[196] Tax-exempt stock ownership will, however, affect the amount of tax that shareholders pay. Thus, the effect of shareholder composition is purely a shareholder- and aggregate-level analysis. Consider the effect that tax-exempt stock ownership has on both the intuitive results (assuming a 65 percent dividend-payout ratio) and the counterintuitive results (assuming a 25 percent dividend-payout ratio) presented above.[197] The analysis will illustrate that tax-exempt ownership causes the negative tax-revenue effects to be greater when the dividend payout ratio is high and to go from positive to negative when the dividend-payout ratio is lower.

a. Conventional Analysis with Tax-Exempt Ownership

Under the conventional analysis (i.e., assuming a 65 percent dividend-payout ratio), the Op Corp dividends were $314 million without the REIT spinoff.[198] If all of those dividends were taxed at 23.8 percent, the shareholders would pay $75 million of tax on the distribution.[199] If tax-exempt investors held 25 percent of Op Corp stock, only 75 percent, or about $236 million, of the distribution would therefore be subject to shareholder tax. At 23.8 percent, the shareholder tax liability would be about $56 million. After paying that tax, the shareholders would have $258 million,[200] and the total tax without the

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25 percent tax-exempt ownership, would therefore be $39.46 ($35 + $4.46) or 39.46 percent of the corporate taxable income. *See* Appendix C.

195. *See supra* text accompanying note 53.

196. *See supra* text accompanying notes 77 and 83, respectively.

197. *See supra* Part III.B.1. (presenting the intuitive results using a conventional analysis); Part III.B.2. (presenting the counterintuitive results using a dynamic analysis).

198. *See supra* text accompanying note 79.

199. *See supra* text accompanying note 112.

200. $314 million distribution – $56 million shareholder tax.

spinoff would be $225 million.[201] Compare those results to the results with a REIT spinoff.

With the REIT spinoff, Op Corp would distribute $227 million,[202] and 75 percent, or about $170 million, of that amount would be subject to the 23.8 percent shareholder tax rate, so the Op Corp shareholders would pay about $40 million of tax on the distribution. Their after-tax amount would be $187 million.[203] The REIT would distribute $134 million of taxable income to its shareholders.[204] If 75 percent, or $101 million, of that distribution is subject to 43.4 percent tax, the REIT shareholders would pay about $44 million of tax. The REIT shareholders' after-tax amount would be $90 million.[205] Under these assumptions, the total tax liability with the spinoff would be about $207 million.[206]

The spinoff with 25 percent tax-exempt ownership thus reduces the total tax liability by $18 million, or 8 percent, which is twice as much as the $9 million reduction that results with no tax-exempt stock ownership.[207] The after-tax amount to the shareholders would be $277 million,[208] which is a $19 million, or 7 percent, increase over the $258 million after-tax amount with no tax-exempt ownership.[209] Table 5 compares the results with and without the spinoff of the arrangement with no tax-exempt owners to the arrangement with 25 percent tax-exempt ownership.

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201. $169 million Op Corp tax + $56 million Op Corp shareholder tax.
202. *See supra* text accompanying note 120.
203. $227 million distribution – $40 million of tax.
204. *See supra* text accompanying notes 84–85.
205. $134 million distribution – $44 million of tax.
206. $123 million Op Corp tax + $40 million Op Corp shareholder tax + $44 million REIT shareholder tax.
207. *See supra* text accompanying notes 129.
208. $187 million for the Op Corp shareholders + $90 million for the REIT shareholders.
209. *See supra* text accompanying note 200.

Table 5: Effect of Tax-Exempt Ownership on Conventional Analysis		
	No Tax-Exempt Ownership	**25% Tax-Exempt Ownership**
No Spinoff		
Op Corp Tax Liability	$169,000,000	$169,000,000
Op Corp Shareholder Liability	$ 75,000,000	$ 56,000,000
Total Tax Liability	$244,000,000	$225,000,000
After-Tax to Shareholders	$240,000,000	$258,000,000
With Spinoff		
Op Corp Tax Liability	$123,000,000	$123,000,000
Op Corp Shareholder Tax Liability	$ 54,000,000	$ 40,000,000
REIT Shareholder Tax Liability	$ 58,000,000	$ 44,000,000
Total Tax Liability	$ 235,000,000	$207,000,000
After-Tax to Shareholders	$ 249,000,000	$277,000,000
Effect on Total Tax Liability REIT Spinoff	-$ 9,000,000 (-0.04%)	-$ 18,000,000 (-8%)
Effect on After-Tax to Shareholder	$49,000,000 (20%)	$19,000,000 (7%)

b. Dynamic Analysis with Tax-Exempt Ownership

Under the dynamic analysis (i.e., assuming a 25 percent dividend-payout ratio), the Op Corp dividends were $121 million absent the REIT spinoff.[210] If all of those dividends were taxed at 23.8 percent, the shareholders would pay $29 million of tax on the distribution.[211] If tax-exempt investors held 25 percent of Op Corp stock, only 75 percent, or about $91 million, of the distributions would be subject to shareholder tax. At 23.8 percent, the shareholder tax liability would be about $22 million. The shareholder after-tax amount would be about $99 million.[212] The total tax without the spinoff would be $191 million.[213]

With the REIT spinoff, Op Corp would distribute $88 million,[214] and 75 percent, or about $66 million, of that amount would be subject to the 23.8

210. *See supra* text between notes 142–143.
211. *See id.*
212. $121 million distribution – $22 million Op Corp shareholder tax
213. $169 million Op Corp tax + $22 million Op Corp shareholder tax.
214. *See supra* text accompanying note 151.

percent shareholder tax rate, so the Op Corp shareholders would pay about $16 million of tax on the distribution.[215] Their after-tax amount would be $72 million.[216] The REIT would distribute $134 million of taxable income to its shareholders.[217] If 75 percent, or $101 million, of that distribution were subject to 43.4 percent tax, the REIT shareholders would pay about $44 million of tax. Their after-tax amount would be $90 million.[218] Thus, under these assumptions, the total tax liability with the spinoff would be $183 million.[219] The spinoff thus reduces the total tax liability by $8 million,[220] or 4 percent, from $191 million[221] to $183 million. The net effect of tax-exempt ownership is therefore a $12 million tax liability decrease.[222]

Tax-exempt ownership therefore causes what would otherwise be a tax-revenue gain to become a tax-revenue loss. The shareholders' after-tax amount would be about $162 million,[223] which is about $62 million,[224] or 63 percent, more than the $99 million after-tax amount with no spinoff.[225] Table 6 compares the results of the dynamic analysis of a REIT spinoff assuming no tax-exempt ownership to the result assuming with 25 percent tax-exempt ownership.

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215. Appendix C includes more detailed computations of these amounts. The numbers in this analysis are rounded, so they may differ slightly from those in Appendix C.

216. $88 million distribution – $16 million Op Corp shareholder tax.

217. *See supra* text accompanying notes 84–85.

218. $134 million REIT dividends – $44 million REIT shareholder tax.

219. $123 million Op Corp + $16 million Op Corp shareholder tax + $44 million REIT shareholder tax.

220. $191 million without the spinoff – $183 million with the spinoff.

221. *See supra* text accompanying note 213.

222. $4 million increase assuming no tax-exempt ownership – $8 million decrease assuming tax-exempt ownership.

223. $72 million for the corporate shareholders + $90 million for the REIT shareholders.

224. $161 million after tax with the spinoff – $99 million without the spinoff.

225. *See supra* text accompanying note 212.

Table 6: Effect of Tax-Exempt Ownership on Dynamic Analysis

	No Tax-Exempt Ownership	**25% Tax-Exempt Ownership**
No Spinoff		
Op Corp Tax Liability	$169,000,000	$169,000,000
Op Corp Shareholder Tax Liability	$ 29,000,000	$ 22,000,000
Total Tax Liability	$198,000,000	$191,000,000
After-Tax to Shareholders	$ 92,000,000	$ 99,000,000
With Spinoff		
Op Corp Tax Liability	$123,000,000	$123,000,000
Op Corp Shareholder Tax Liability	$ 21,000,000	$ 16,000,000
REIT Shareholder Tax Liability	$ 58,000,000	$ 44,000,000
Total Tax Liability	$202,000,000	$182,000,000
After-Tax to Shareholders	$142,000,000	$162,000,000
Effect of REIT Spinoff on Total Tax Liability	$ 4,000,000 (2%)	-$8,000,000 (-4%)
Effect of REIT Spinoff on After-Tax to Shareholders	$ 50,000,000 (54%)	$ 62,000,000 (63%)

The analysis with tax-exempt ownership shows that REIT spinoffs can reduce tax revenue, even if the corporation's dividend-payout ratio is in line with typical corporate behavior. Nonetheless, the overall tax-revenue effect is much smaller than the effect of corporate-tax-base erosion. The effect of foreign ownership of spun-off REITs is less pronounced, but it too alters the tax-revenue effect of a REIT spinoff. The discussion below shows that foreign ownership counterintuitively has a greater influence on the tax-revenue effect of partnership-to-REIT formations.[226]

c. *Influence of Foreign Ownership*

The analysis can determine how foreign ownership influences the tax-revenue effect of a REIT spinoff by comparing the results from the completed analysis to the results using the effective tax rates from above that account for the full composition of corporate and REIT shareholders, including foreign shareholders.[227] Shareholder composition does not alter the amount of tax that the corporation pays, so this analysis uses the $169 million of Op Corp tax liability without the REIT spinoff and the $123 million Op Corp tax liability with the spinoff and focuses on computing shareholder liability.

226. *See infra* Part IV.C.

227. *See supra* text accompanying notes 166–179.

Recall that with the full composition of shareholders, the effective Op Corp shareholder tax rate would be 16.71 percent,[228] and the effective REIT shareholder tax rate would be 26.59 percent.[229] Now consider the tax-revenue effect of the REIT spinoff, assuming Op Corp's dividend-payout ratio is 25 percent. Without the REIT spinoff, Op Corp would distribute $121 million,[230] and at the 16.71 percent effective tax rate, the Op Corp shareholders would pay about $20 million of tax on the distribution. Thus, the total tax without the spinoff would be about $189 million.[231] The after-tax amount to the shareholders would be $101 million.[232]

With the REIT spinoff, Op Corp would distribute $88 million,[233] so the Op Corp shareholders would pay about $15 million of tax at 16.71 percent. The REIT would distribute $134 million of taxable income, and, assuming the REIT shareholder effective tax rate is 26.59 percent, the REIT shareholders would pay about $36 million of tax on the distribution. Thus, with the full composition of shareholders, the total tax with the spinoff would be $174 million.[234] The after-tax amount to the shareholders would be $171 million.[235]

Including foreign ownership of stock in the analysis changes the tax-revenue effect. With the full composition of shareholders, the REIT spinoff reduces the total tax by $15 million.[236] When the analysis considered only tax-exempt ownership, the tax-revenue effect of the REIT spinoff was an $8 million reduction.[237] The tax-revenue effect with the full composition of shareholders is therefore $7 million greater than it was when the analysis assumed only individual and tax-exempt ownership of the corporate and REIT stock. Thus, the tax-revenue effect of foreign ownership on a REIT spinoff is less than the $12 million tax-revenue effect of tax-exempt ownership.[238] The REIT spinoff increases the shareholder after-tax amount by $70 million.[239] That is $8 million better than the $62 million difference determined without considering the effect of foreign ownership.[240] The difference illustrates that modifying the variables used in the dynamic analysis can alter the tax-revenue

228. *See supra* Table 4.

229. *See id.*

230. *See supra* text accompanying notes 142–143.

231. $169 Op Corp tax + $20 million Op Corp shareholder tax.

232. $121 million distribution – $20 million Op Corp shareholder tax.

233. *See supra* text accompanying note 151.

234. $123 million Op Corp tax + $15 million Op Corp shareholder tax + $36 million REIT shareholder tax.

235. $222 million distribution – $51 million total shareholder tax.

236. $189 million total tax without the spinoff – $174 million total tax with the spinoff.

237. *See supra* text accompanying note 220.

238. *See supra* text accompanying note 222.

239. $171 million with the spinoff – $101 million without the spinoff.

240. *See supra* text accompanying note 224.

effect of a REIT spinoff. Therefore, analyses of REIT spinoffs must consider all of the variables to determine their tax-revenue effect. The following discussion provides a mathematical model for analyzing the operational tax-revenue effect of REIT spinoffs.

4. *Mathematical Model of Operational Tax-Revenue Effect*

The analysis to this point illustrates how changes to variables can alter the tax-revenue effect of a REIT spinoff. The analysis also provides the opportunity to distill formulas and create models that can have broader application and further illustrate the tax-revenue effect of REIT spinoffs. The following formulas incorporate the variables used to determine the operational tax-revenue effect of a REIT spinoff. In addition to determining the operational tax-revenue effect of a REIT spinoff, the formulas can help identify the point at which a REIT spinoff would have no operational tax-revenue effect, identify the variables that influence the tax-revenue effect the most, and pinpoint the value of a single variable that causes a REIT spinoff to be tax-revenue neutral. Formula (1) determines the tax liability without a spinoff and accounts for the dividend payout ratio (*P*), tax-exempt ownership (*V*), foreign ownership (*F*), and the respective tax rates. The first term $(I_C \times T_C)$ is the corporate tax liability. The second term $\left((I_C \times P) \times T_S \times (1 - V + F)\right)$ is the liability of the individual domestic corporate shareholders, and the third term $(I_C \times P \times F \times T_F)$ is the tax liability of the foreign shareholders. The tax liability without the spinoff is merely the corporation's tax liability plus the corporate shareholders' tax liability.

Formula (2) determines the total tax liability with a spinoff. It modifies the first clause by reducing the corporate tax base by the amount of taxable income (I_R) that shifts to the REIT as part of the spinoff. It also modifies the computation of the corporate shareholder liability by ensuring the dividend payout reflects the change in corporate taxable income $(I_C - I_R)$. Finally, it adds the terms for the REIT individual shareholder tax liability $\left(I_R \times T_R \times (1 - V + F)\right)$ and for REIT foreign shareholder tax liability $(I_R \times T_F \times F)$. Formula (3) simply subtracts formula (2) from formula (1) to determine the amount of tax revenue lost as a result of a REIT spinoff. Formula (4) sets formula (1) equal to formula (2) to determine what the variables must be for the spinoff to be revenue neutral. Finally, Formula (5) is a simplified version of (4),[241] showing the point at which the REIT spinoff has no operational tax-revenue effect, with fewer moving parts.

241. The simplification process is in Appendix E.

Mathematical Models of Operational Tax-Revenue Effect of REIT Spinoffs

(1) *Tax Liability without Spinoff*:

$$(I_C \times T_C) + \left((I_C \times P) \times T_S \times \left(1 - (V + F)\right)\right) + (I_C \times P \times F \times T_F)$$

(2) Tax *Liability with Spinoff*:

$$\left((I_C - I_R) \times T_C)\right) + \left(\left((I_C - I_R) \times P\right) \times T_S \times \left(1 - (V + F)\right)\right) + \left((I_C - I_R) \times P \times F \times T_F\right) + \left(I_R \times T_R \times \left(1 - (V + F)\right)\right) + (I_R \times T_F \times F)$$

(3) *Overall Tax-Revenue Effect of REIT Spinoff*:

$$(I_C \times T_C) + \left((I_C \times P) \times T_S \times \left(1 - (V + F)\right)\right) + (I_C \times P \times F \times T_F) - \left(\left((I_C - I_R) \times T_C)\right) + \left(\left((I_C - I_R) \times P\right) \times T_S \times \left(1 - (V + F)\right)\right) + \left((I_C - I_R) \times P \times F \times T_F\right) + \left(I_R \times T_R \times \left(1 - (V + F)\right)\right) + (I_R \times T_F \times F)\right)$$

(4) *Tax-Revenue-Neutral Spinoff*:

$$(I_C \times T_C) + \left((I_C \times P) \times T_S \times \left(1 - (V + F)\right)\right) + (I_C \times P \times F \times T_F) = \left((I_C - I_R) \times T_C)\right) + \left(\left((I_C - I_R) \times P\right) \times T_S \times \left(1 - (V + F)\right)\right) + \left((I_C - I_R) \times P \times F \times T_F\right) + \left(I_R \times T_R \times \left(1 - (V + F)\right)\right) + (I_R \times T_F \times F)$$

(5) *Simplified Version of Tax-Revenue-Neutral Spinoff*:

$$T_C = T_R(1 - V - F) - T_S(P - PV - PF) + T_F(F - FP)$$

Where: I_C = corporate taxable income assuming no spinoff
I_R = REIT taxable income
T_C = corporate tax rate
T_S = corporate shareholder tax rate
T_R = REIT shareholder tax rate
T_F = foreign shareholder tax rate
P = corporate dividend-payout ratio
V = tax-exempt stock-ownership percentage
F = foreign stock-ownership percentage

The mathematical presentation of the operational tax-revenue effect of REIT spinoffs reveals important insights about the relative importance of the variables. First, Formulas (3) (tax-revenue-neutral spinoff) and (4) (overall tax-revenue lost) have nine variables. Formula (5), the simplified version of the Formula (4), has only seven variables. The two variables that are not in the simplified version are the corporate income tax without the spinoff and the amount of corporate income that migrates to the REIT as part of the spinoff. Those two variables represent erosion of the corporate tax base. The formulas therefore provide mathematical proof that corporate-tax-base erosion is not important in determining whether a REIT spinoff will negatively or positively affect operational tax revenue. Instead, the amount of lost corporate tax base is only relevant for determining the amount of the tax-revenue effect, once the direction of the effect is known. This result confirms that the focus on corporate-tax-base erosion by those analyzing the tax-revenue effect of REIT spinoffs is misplaced because the tax-revenue effect of a spinoff could be positive or negative regardless of the corporate-tax-base erosion.

Second, the formulas show that possible tax-revenue-effect outcomes from REIT spinoffs are very large because the variables could differ from spinoff to spinoff. Consequently, generalizations about the operational tax-revenue effect of REIT spinoffs could be grossly inaccurate. Others have recognized this and have concluded that some industries are more conducive to REIT spinoffs than others.[242] Some general observations about the variables show that the tax-revenue effect of REIT spinoffs could vary significantly from entity to entity depending upon the values of the different variables. For instance, if a corporation had a lower effective tax rate or consistently had low taxable income, such as some are reported to have,[243] a REIT spinoff would not significantly reduce corporate tax, but it should increase overall tax revenue because the spinoff would move taxable income to tax-paying shareholders. Lower dividend-payout ratios would tend to cause the tax-revenue effect of a REIT spinoff to move positively because the spinoff would result in more taxable income flowing to shareholders taxed at potentially higher rates. Shareholder composition is also very important. The larger

242. *See* Goolsbee & Maydew, *Organizational Form*, *supra* note 54, at 443 (concluding that the industries with the greatest potential net tax benefits from REIT spinoffs are nursing homes and railroads).

243. *See* Robert S. McIntyre et al., CITIZENS FOR TAX JUSTICE AND THE INSTITUTE ON TAXATION AND ECONOMIC POLICY, *The Sorry State of Corporate Taxes: What Fortune 500 Firms Pay (or Don't Pay) in the USA And What they Pay Abroad—2008 to 2012*, (February 2014) [hereinafter The CTJ Report], http://www.ctj.org/corporatetaxdodgers/sorrystateofcorptaxes.pdf (claiming that the effective tax rate of corporations varies significantly, with a substantial percentage paying less than the 35 percent statutory rate); Kevin Drawbaugh & Patrick Temple-West, *Many Big U.S. Corporations Pay Very Little in Taxes: Study*, REUTERS (Feb. 25, 2014), http://www.reuters.com/article/2014/02/26/us-usa-tax-corporate-idUSBREA1P04Q20140226 (reporting, based upon the CTJ report, that from 2008 to 2012, Boeing, General Electric, and Verizon Communications paid no federal income tax). As noted above, the effective corporate tax rate is a point of contention. *See supra* note 48.

percentage of shareholders that are tax-exempt, the more a REIT spinoff will reduce tax revenue.

The application of the equation, helps illustrate the significant influence tax-exempt ownership has on the tax-revenue effect of the REIT spinoff. The following example assumes that Op Corp's taxable income without the spinoff is $484 million,[244] the spinoff moves $134 million of taxable income to the REIT,[245] foreign stock ownership is 0 percent,[246] Op Corp's dividend payout ratio reflects the average 25 percent corporate payout ratio,[247] and the tax rates are those stated above (35 percent for Op Corp, 23.8 percent for Op Corp individual shareholders, 43.4 percent for REIT shareholders, and 15 percent for foreign shareholders).[248] These assumptions leave only the amount of tax-exempt ownership unknown. Formula (4) helps determine that if tax-exempt entities own more than 6.54 percent of Op Corp and REIT stock, the tax-revenue effect of the REIT spinoff will be negative.[249] Thus, with a typical REIT spinoff, even if tax-exempt ownership of the corporation's and REIT's stock is fairly low, the spinoff will have a negative effect on tax revenue. Consequently, shareholder composition is a critical variable for determining the tax-revenue effect of a REIT spinoff.

Third, Formula (5) can incorporate the tax-rate assumptions that the analysis has used to this point,[250] to provide the maximum amounts that the other variables could be without causing the tax-revenue effect to be negative. The application computes the thresholds when the other remaining variables are set to zero. Thus, if only individuals hold stock in both the corporation and the REIT, the tax-revenue effect of a REIT spinoff will be negative if the corporation's dividend-payout ratio exceeds 35.3 percent (*see* Formula (6)). If the corporation's dividend-payout ratio is zero and tax-exempt stock ownership is zero, the tax-revenue effect of a REIT spinoff will be negative if foreign stock ownership exceeds 29.6 percent (*see* Formula (7)). Finally, if the dividend-payout ratio and foreign stock ownership are both zero, then the tax-revenue effect of the REIT spinoff will be negative if tax-exempt stock ownership exceeds 19.4 percent (*see* Formula (8)).

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244. *See supra* text accompanying note 76.

245. *See supra* text accompanying notes 84–86.

246. If this variable reflected the 21 percent provided above, *see supra* text accompanying note 177, the spinoff would reduce tax revenue, and any amount of tax-exempt ownership would increase the tax cost of the spinoff. Therefore, this assumption assumes foreign ownership is zero for the sake of analysis.

247. *See supra* text accompanying note 45.

248. *See supra* text accompanying notes 47–53, 179.

249. *See* Appendix F (providing the calculations under these assumptions).

250. *See supra* text accompanying notes 47–53, 179.

Application of Operational-Effect Model
General Assumptions: $T_C = 0.35$, $T_R = 0.434$, $T_S = 0.238$, $T_F = 0.15$:
$\mathbf{0.35 = 0.434 - 0.434V - 0.434F - 0.238P + 0.238PV + 0.238PF + 0.15F - 0.15FP}$
(6) *Assumption 1:* V *and* $F = 0$:
$\mathbf{0.35 = 0.434 - 0.238P}$
$\mathbf{P = 35.3\%}$
(7) *Assumption 2:* P *and* $V = 0$:
$\mathbf{0.35 = 0.434 - 0.434F + 0.15F}$
$\mathbf{F = 29.6\%}$
(8) *Assumption 3:* F *and* $P = 0$:
$\mathbf{0.35 = 0.434 - 0.434V}$
$\mathbf{V = 19.4\%}$

These results indicate that tax-exempt stock ownership influences the tax-revenue effect of a REIT spinoff more than the other variables. After gaining a thorough understanding of the variables that influence the tax-revenue effect of a REIT spinoff, that conclusion is not surprising. A REIT spinoff moves corporate taxable income into a REIT, which is not subject to an entity-level tax. Income that flows through a REIT to a tax-exempt shareholder will not be subject to tax currently. That income would have been subject to the entity-level corporate tax, had it stayed in the corporation. Thus, REIT spinoffs do allow a portion of income from real estate to escape tax entirely. If the percentage of tax-exempt stock ownership continues to grow, then REIT spinoffs could pose a significant tax-revenue-effect problem. Congress could address that concern by prohibiting REIT spinoffs, changing the rules governing tax-exempt entities, or limiting the percentage of REITs that tax-exempt entities can hold.[251] Congress should, however, consider other tax-revenue effects before changing current laws.

C. *Transactional Tax-Revenue Effect of a REIT Spinoff*

The analysis to this point has considered only the operational tax-revenue effect of REIT spinoffs. To fully assess the tax-revenue effect of REIT spinoffs, the analysis must consider the effect REIT spinoffs have on stock prices and any selloff that results after a REIT spinoff. One report claims that the price of the spinoff corporation's stock increases 13 percent to 82 percent

251. *See* Borden, *Reforming REIT Taxation*, *supra* note 15 (considering various REIT reform alternatives).

following the announcement of a REIT spinoff.[252] REIT spinoffs will also affect the asset allocation of many investors' portfolios, and some investors, such as index mutual funds, will likely sell or purchase stock in either the new REIT or the old corporation following a REIT spinoff to preserve the appropriate asset allocation.[253] Turning over assets in that manner could trigger tax on any gain recognized by the seller, including any spinoff premium. That transactional tax-revenue effect could offset some of the operational tax revenue otherwise lost as the result of a REIT spinoff. The example of Op Corp helps illustrate how the surge in stock price and stock selloffs to facilitate fund asset-allocation adjustments can result in increased tax revenue.

Assume that prior to the announcement of the REIT spinoff, Op Corp had a market capitalization of $5 billion.[254] A group of industry-specific funds hold 25 percent, or $1.25 billion, of the outstanding value of Op Corp's stock. The average adjusted basis the funds had in that stock was $564 million. Thus, the built-in gain of the stock held by the funds would have been $686 million.[255] The Op Corp stock the funds held constituted 2.5 percent of the total value of the funds' $50 billion in assets. The funds use strict formulas to maintain the appropriate asset allocation, so they sell or acquire stock as appropriate to keep their asset allocations in balance.

The announcement that Op Corp would spinoff $6 billion of assets and liabilities caused the market value of the Op Corp stock to jump 20 percent to $6 billion, and, following the spinoff, Op Corp's stock had a market value of $4 billion, and the REIT stock had a market value of $2 billion. As part of the spinoff, Op Corp distributed REIT stock in proportion to the shareholders' interests in Op Corp, so the group of funds would hold 25 percent of Op Corp stock ($1 billion) and 25 percent of the REIT stock ($500 million) following

252. *See* Al Rosen & Mark Rosen, *REIT Spinoffs Create Value*, advisor.ca (Mar. 12, 2013), http://www.advisor.ca/investments/market-insights/reit-spinoffs-create-value-109972.

253. *See* William F. Sharpe, *Adaptive Asset Allocation Policies*, 66 FIN. ANALYSTS J. 45, 45–47 (2010) (describing how pension funds and multi-asset mutual funds "rebalance their holdings after major market moves in order to minimize differences between actual and policy asset allocations").

254. Data or estimates regarding shareholder reactions to REIT spinoffs do not appear to be readily available. Consequently, the assumptions in this example are purely illustrative and may not necessarily reflect the actual behavior of funds. Nonetheless, funds adopt strict asset-allocation requirements and many use formulas to make decisions about purchases and dispositions that help maintain the appropriate asset-allocations. Thus, the overall concept is reasonable and should be a part of the tax-revenue-effect analysis of REIT spinoffs. The results of this hypothetical could overstate or understate the actual tax-revenue effect of spinoffs, and the effect would likely vary from company to company and industry to industry. The example, therefore, has significant value in illustrating the issue, but leaves more specific analysis to future work in this area.

255. $1.25 billion value – $564 million adjusted basis.

the spinoff. Based upon the post-spinoff proportionate values of the Op Corp and REIT stock, the funds apportioned their pre-spinoff $564 million adjusted basis $376 million (two-thirds) to the post-spinoff Op Corp stock and $188 million (one-third) to the REIT stock.[256] Thus, following the spinoff, the funds hold $1 billion of Op Corp stock with a $376 million adjusted basis and a built-in gain of $624 million.[257] They also hold $500 million of REIT stock with a $188 million basis and a built-in gain of $312 million.[258] The total built-in gain thus becomes $936 million,[259] a $250 million increase following the spinoff announcement.[260]

To maintain the appropriate asset allocation, the funds must sell all $2 billion of the REIT stock (none of the funds invests in real estate assets), and must acquire $250 million of Op Corp stock to maintain their original $1.25 billion balance, or 2.5 percent of total assets. Assume the funds are RICs that distribute their capital-gain income to taxable shareholders who report and pay tax on the income at favorable long-term capital gain rates of 23.8 percent.[261] Upon sale of the REIT stock, the funds will recognize and distribute the $312 million of gain. At 23.8 percent, the funds' shareholders will pay $74 million of tax on that gain. The funds will not recognize any gain on the acquisition of $250 million of Op Corp stock, but the sellers of that stock will recognize gain. Assume the only gain that the sellers recognize is attributable to the 20 percent price surge following the announcement of the REIT spinoff. That amount would be about $42 million of the $250 million purchase price.[262] At 23.8

256. *See* I.R.C. § 358(b); Reg. § 1.358-2(a)(2)(iv).

257. $1 billion value – $376 million adjusted basis.

258. $500 million value – $188 million adjusted basis

259. $623 million from Op Corp stock + $312 million from REIT stock.

260. $936 million after the spinoff announcement – $686 million before the spinoff announcement.

261. *See supra* note 168 (discussing RICs); *supra* text accompanying note 47 (discussing applicable tax rates). The estimated tax rate used in this part of the analysis is likely higher than the actual rate because some RIC shareholders will be exempt from tax, and some will have incomes that are low enough that they will not owe the 3.8 percent Medicare surtax. *See* INVESTMENT COMPANY INSTITUTE, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2013*, 19 ICI RESEARCH PERSPECTIVE 1–8 (Oct. 2013), http://www.ici.org/pdf/per19-09.pdf (reporting that 69 percent of households with income greater than $50,000 of income held mutual funds and 67 percent of the mutual funds were held inside retirement accounts). Because the sell-off numbers are hypothetical, this analysis adopts the 23.8 percent rate, which would be on the high side, to illustrate a possible transactional tax-revenue effect. Perhaps the amount of gain that is not long term, *see infra* note 263, and would not qualify for the favorable rate, would offset the difference in this part of the analysis. This Article leaves that part of the analysis for future work.

262. A 20 percent price increase is equal to roughly 16.67 percent ($1 billion ÷ $6 billion) of the after-increase value of the stock. Assuming the only gain the sellers

percent,[263] the tax on the $42 million of gain would be about $10 million. Thus, the total tax paid as a result of the funds selling and buying stock following the spinoff would be $84 million.[264] Of that amount, about $22 million is from the surge in stock price following the spinoff announcement.[265] The positive transactional tax-revenue effect of the REIT spinoff appears to offset the negative operational tax-revenue effect of the REIT spinoff.[266]

D. *Overall Tax-Revenue Effect of a REIT Spinoff*

A complete tax-revenue analysis should consider both the transactional and operational tax-revenue effects of a REIT spinoff. Formula (9) expresses the transactional tax-revenue effect of a REIT spinoff. That formula, combined with Formula (3), provides a more accurate breakeven point of a REIT spinoff. Formula (3) provides only a single year's operational tax-revenue effect of the REIT spinoff, but the operational tax-revenue effect continues on an annual basis following a REIT spinoff. Consequently, a complete analysis of the tax-revenue effect of a REIT spinoff would have to estimate how the REIT spinoff would affect tax revenue in future years and discount those effects to present value to provide an adequate point of comparison to the current transactional tax-revenue effect. Formula (10) therefore uses E to represent the operational tax-revenue effect of a REIT spinoff for any given year, and discounts the future effects to present value.

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recognize is attributable the price surge, the gain will be 16.67 percent of the $250 million stock price, or roughly $42 million.

263. The example continues to use the 23.8 percent rate for the gain recognized by the sellers, even though assuming the gain equals the price surge suggests that the sellers have not held the Op Corp stock long enough to qualify for favorable long-term capital gains rates. The assumption that 23.8 percent applies provides a conservative estimate of the tax effect result from post-spinoff sales.

264. $74 million from the sale of REIT stock + $10 million from the sale of Op Corp stock.

265. The $22 million is the sum of the $10 million of tax from the sale of the Op Corp stock plus 16.67 percent of $47 million, or about $12 million, of tax from the sale of the REIT stock. *See supra* note 262 (computing the 16.67 percent).

266. This Article does not attempt to compute the tax-revenue effect of purging dividends that occur as part of REIT spinoffs, but because they are taxable, they too would have a positive tax-revenue effect and further minimize the negative tax-revenue effect of a REIT spinoff.

Mathematical Model of Transactional Tax-Revenue Effect of REIT Spinoff
(9) *Transactional Tax-Revenue Effect of a REIT Spinoff*: $\left(D \times H_R \times T_D \times (1 - V_R)\right) + \left(B \times H_C \times T_P(1 - V_S)\right)$ (10) *Breakeven Point Considering Tax-Revenue Effect of Sale Off*: $\left(D \times H_R \times T_D \times (1 - V_R)\right) + \left(B \times H_C \times T_P(1 - V_S)\right) = \sum_{n=1}^{N} \frac{E_n}{(1 + r)^n}$ *Where*: D = built-in gain on REIT stock H_R = % of REIT stock sold as result of spinoff T_D = tax rate applied to sellers of REIT stock V_R = % of gain from sale of REIT stock allocated to tax-exempt owners B = built-in gain of Op Corp stock H_C = % of Op Corp stock sold as a result of spinoff T_P = tax rate applied to gain from sale of Op Corp stock V_S = % of gain from sale of Op Corp stock allocated to tax-exempt owners E = Formula (3) r = discount rate

The $84 million of transactional tax revenue that results from funds selling and acquiring stock following the REIT spinoff should offset potential operational tax-revenue loss following the REIT spinoff. Recall that the operational tax-revenue loss from the spinoff could be as great as $15 million per year under certain reasonable assumptions.[267] The $84 million of tax revenue gained as a result of investors balancing their portfolios following the spinoff offsets about seven years' worth of the tax revenue lost from post-spinoff operations.[268] Changes to the assumptions used in this hypothetical would, of course, change the revenue effect of transactions that occur as a result of a REIT spinoff.

267. *See supra* text accompanying note 236 (assuming Op Corp's dividend-payout ratio and tax-exempt ownership were each 25 percent).

268. The present value of $15 million of lost tax revenue for 7 years, using a 5 percent discount rate, is $87 million, computed using the following equation: $\sum_{n=1}^{7} \frac{15}{(1+0.05)^n}$.

Formula (10) provides a more accurate result, but it is not perfect because it treats the transactional tax-revenue as occurring at a single point in time. In fact, if the REIT spinoff causes a stock-price surge, that price increase will affect gain recognized by shareholders for years to come. Thus, the $1 billion of stock-price surge in the Op Corp example could generate as much as $238 million of tax over time, assuming the gain will be taxed at 23.8 percent.[269] Of course, any of that transactional gain recognized after the spinoff would have to be discounted to present value to accurately compare it to the discounted present value of the operational tax-revenue effect. Formula (10) also takes into account all of the gain recognized by the shareholders on the sale of the REIT stock. Without the REIT spinoff, the shareholders may have eventually sold that stock and recognized the pre-announcement built-in gain at some point in the future. The analysis should account for the tax that would be paid on that gain in the future by discounting it to present value and offsetting it against the tax paid currently as a result of the disposition of the REIT stock.

This analysis illustrates that the tax-revenue effects of a REIT spinoff are not certain, but tax-base erosion is just one of many variables that influences the tax-revenue effect. Even though REIT spinoffs will most likely erode the corporate tax base, other variables more profoundly influence the tax-revenue effect of the spinoff. Consequently, each spinoff may produce results that differ from other spinoffs and general intuitive expectations. Therefore, each spinoff must be carefully studied to determine its tax-revenue effect and whether shareholders would approve a spinoff if it did not reduce the overall taxes on income from the real estate. The Miller and Modigliani Irrelevancy Theorem suggests that if REIT spinoffs do not provide tax savings, shareholders would not approve them simply to obtain higher dividend payouts.[270] Based upon that theory, the announcement of a REIT spinoff should cause the stock price of the announcing corporation to lose value, if the REIT spinoff would not provide tax savings. Nonetheless, there are several potential reasons why shareholders might approve a REIT spinoff even if they believed it might not reduce the overall tax liability of the shareholders and corporation. These reasons may help explain why spinoffs enhance

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269. $1 billion x 23.8%.

270. *See* Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411, 414 (1961) ("Thus, we may conclude that given a firm's investment policy, the dividend payout policy it chooses to follow will affect neither the current price of its shares nor the total return to its shareholders."). *But see* Peter H. Huang & Michael S. Knoll, *Corporate Finance, Corporate Law and Finance Theory*, 74 S. CAL. L. REV. 175, 179–91 (2000) (showing that the Irrelevancy Theorem breaks down with different assumptions).

shareholder value in the face of potential increased costs.[271] First, tax-exempt shareholders may be the largest class of shareholders or may exert the most influence over corporate decision makers.[272] Because such entities do not pay tax, they may not be concerned about the higher tax rate that applies to REIT dividends received by individuals or other taxable shareholders.

Second, even taxable shareholders may prefer having the greater after-tax distributions that they receive following a REIT spinoff.[273] Because REITs must distribute taxable income but corporations are not required to make distributions, shareholders can receive considerably greater distributions with a REIT spinoff.[274] The additional overall taxes that the corporation and shareholders pay with a REIT spinoff come as a result of the disproportionately larger distributions. Even though the value of corporate stock should reflect the lower taxes paid by the corporation which retains earnings absent a REIT spinoff, shareholders appear to give greater value to larger taxable distributed earnings.[275] Shareholders therefore appear to attach a premium to REITs because REITs pay dividends regularly.[276] Third, the increased stock price resulting from a REIT spinoff announcement may offset the higher operational taxes paid as a result of the spinoff. Consequently, even though a REIT spinoff may result in greater tax revenue for the government and greater tax costs to taxpayers, taxpayers may prefer the REIT spinoff for various other reasons. The bigger question may be whether the aggregate tax-revenue effect of REIT spinoffs and REIT taxation warrant the attention that they have received.

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271. *See* Goolsbee & Maydew, *Organizational Form*, *supra* note 54, at 443–44 (attributing the attractiveness of a spinoff to enhancement of shareholder value).

272. *See* Paul Bouchey, *Tax-Efficient Investing in Theory and Practice*, Parametric White Paper, at 2 (Spring 2010) ("[Tax-exempt] accounts tend to receive more attention from the investment management community.").

273. *See* Michael Santoli, *Changing Their Stripes*, BARRON'S (May 19, 2012),http://online.barrons.com/articles/SB50001424053111904571704577406161684395748 (attributing REIT growth and improved REIT market value to "investors' rabid appetite for income-producing investments").

274. *See supra* Part III.B.2.

275. *See* Amy S. Elliott, *The Expanding Universe of REITs*, 137 TAX NOTES 707, 707 (Nov. 12, 2012).

276. *See* Anderson Forest, *Now, Dividend Hunters are Stalking REITs*, BUS. WEEK 120–21 (June 5, 1994). *See also* Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L. J. 325, 348 (1995) (recognizing that shareholders dislike corporate retained earnings financing because it insulates managers from scrutiny).

IV. AGGREGATE TAX-REVENUE EFFECT OF REIT TAXATION

The focus to this point has been on a single REIT spinoff. The dynamic analysis illustrates how a spinoff erodes the corporate tax base and can affect tax revenue positively or negatively. The focus now turns to estimating the aggregate tax-revenue effect of REIT spinoffs and other REIT formations. Several analysts have considered the tax-revenue effect of REIT spinoffs, and their conclusions support a general finding of modest effect. Unfortunately, some of the published estimates of the tax-revenue effect of REIT spinoffs appear to focus only on the erosion of the corporate tax base, so they miscalculate and potentially overstate the overall tax-revenue effect of REIT spinoffs. Furthermore, they appear to ignore REITs that form from partnerships.

The following discussion employs the dynamic analysis introduced above to better estimate the tax-revenue effect of REIT spinoffs, the tax-revenue effect of partnership-to-REIT formations, and the overall tax-revenue effect of REIT taxation. The analysis shows that some estimates significantly overstate the effect. The analysis relies upon information available with respect to publicly traded REITs. Publicly-traded REITs account for about 20 percent of the total number of REITs.[277] Unfortunately, information about closely-held REITs is not publicly available. Publicly-traded REITs should be larger on average than privately-held REITs because they have access to public capital, so publicly-trade REITs could account for the lion's share of total REIT taxable income, even though they are only a relatively small percentage of the total number of REITs. Thus, even though the conclusions in this Article could understate the tax-revenue effect of REIT taxation, they illustrate that the effect is modest, and that partnership-to-REIT formations likely account for most of that effect.

A. *Estimates of Tax-Revenue Effect of REIT Spinoffs*

The Joint Committee on Taxation estimates the tax–revenue effect of the Camp Proposal to prohibit tax-free REIT spinoffs. According to that estimate, REIT spinoffs will cost $9.5 billion of tax revenue over the next ten years.[278] That means REIT spinoffs cost $950 million on average per year with

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277. Approximately 1,100 REITs file tax returns. *See* REIT.COM, *The Basics of REITs*, http://www.reit.com/investing/reit-basics/reit-faqs/basics-reits (last visited Sept. 25, 2014) [hereinafter REIT.COM, *The Basics of REITs*]. Of that amount, 202 are publicly traded. *See* Appendix A.

278. *See* STAFF OF JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATED REVENUE EFFECTS OF THE "TAX REFORM ACT OF 2014," JCX-20-14, p. 10 (Comm. Print 2014) [hereinafter JOINT COMM., ESTIMATED EFFECTS].

the cost in 2015 being as low as $200 million.[279] That amount is a paltry 0.35 percent of the $274 billion corporate income tax revenue and 0.03 percent of the $2.775 trillion total receipts by the government in 2013.[280] Other estimates of lost tax revenue vary from this one, but they suggest that the overall tax-revenue effect of REIT spinoffs is modest at best and that analysts probably will not reach a consensus about the effect of REIT taxation.

One such study by Martin Sullivan, the economist referred to in the introduction,[281] suggests that the annual effect on revenue that results from twenty REIT conversions would be between $900 million and $2.2 billion per year (based on 2014 profit estimates).[282] That estimate only considers 20 of the 1,100 REITs that are reported to have filed tax returns,[283] but it does not appear to account for the increased tax rate that REIT shareholders pay or for the larger distributions that follow the REIT distribution requirement.[284] Consequently, it overstates the tax-revenue effect. In fact, the estimate appears to be fairly close to the aggregate tax-revenue effect of REIT taxation of all publicly-traded REITs, which derives primarily from partnership-to-REIT formations.[285] Nonetheless, with corporate income taxes estimated to be $333 billion,[286] the lost revenue based upon this estimate would be no more than 0.66 percent of the total corporate tax revenue. The effect on the $2.775 trillion total government receipts is no more than 0.079 percent. Consequently, even though the estimate overstates the tax-revenue effect, the study shows that the effect is modest.

A 2002 study reached a significantly different conclusion, even though it considered rate differentials. That study estimated potential lost tax revenue from REIT spinoffs for the ten industries with the largest potential for

279. *See id.* The Joint Committee's estimate takes into account numerous variables, including other changes in the Camp proposal. Undoubtedly, the estimate relies upon a very sophisticated model created over decades and information that is not available to the public. *See generally* Emil M. Sunley & Randall D. Weiss, *The Revenue Estimating Process*, 10 AM. J. TAX POL'Y 261 (1992) [hereinafter Sunley & Weiss, *Estimating Process*] (describing the revenue estimating process).

280. *See* OFFICE OF MGMT. AND BUDGET, HISTORICAL TABLES, TABLE 2.1—RECEIPTS BY SOURCE: 1934–2019, http://www.whitehouse.gov/omb/budget/historicals.

281. *See supra* note 4 and accompanying text.

282. *See* Martin A. Sullivan, *The Revenue Costs of Nontraditional REITs*, 144 TAX NOTES 1103, 1104 (Sept. 8, 2014) [hereinafter Sullivan, *Revenue Costs*].

283. *See* REIT.COM, *The Basics of REITs*, *supra* note 277.

284. *See supra* text accompanying notes 51–53 (discussing REIT dividends' ineligibility for favorable dividend rates); Sullivan, *Revenue Costs*, *supra* note 282, at 1104 (recognizing that his analysis did not account for increases in individual tax revenues because of REIT distribution requirements).

285. *See infra* text accompanying notes 424–429, 431.

286. *See supra* note 280.

tax savings could be about $2.6 billion per year.[287] That amount was net of the estimated $4.9 billion reduction in corporate taxes and a $2.3 billion increase in shareholder taxes.[288] Total corporate income tax revenue for 2002 was $148 billion,[289] so the estimated $4.9 billion decrease would represent a 3.3 percent decrease in corporate tax revenue. The $2.3 billion increase in shareholder taxes would represent a 0.27 percent increase to the $858 billion of individual income tax revenue in 2002.[290] The overall effect of the net tax savings is a very small part of total tax revenue. Total tax revenue for 2002 was $1.853 trillion,[291] so the $2.6 billion net tax savings that REIT spinoffs could have generated for the top ten industries would be a paltry 0.14 percent of the total government receipts for 2002.

These results indicate that the significance of the tax-revenue effect of REIT spinoffs depends upon the tax base under consideration. If the focus is on the corporate tax base, the effect will appear to be more significant as a percentage of corporate tax revenue. If the focus turns to total government receipts, the percentage of lost tax revenue will be considerably smaller. The appropriate point of comparison would appear to be total government receipts because REIT spinoffs reduce corporate tax, but they increase shareholder tax liability because REITs must distribute taxable income and REIT distributions do not qualify for favorable dividend tax rates.[292] Thus, the analysis should compare the net effect of REIT spinoffs and REIT taxation to total government receipts. Compared to total government receipts, the tax-effect of REIT spinoffs is miniscule, and as the following discussion will demonstrate, the aggregate tax-revenue effect of REIT taxation is very modest.

B. *Analysis of Estimates of REIT-Spinoff Effect*

Publicly available information provides the basis for considering the tax-revenue effect of REIT spinoffs and the overall effect of REIT taxation and whether REIT spinoffs are eroding the corporate tax base at a significant cost or significantly affecting overall tax revenue. The information also provides the opportunity to consider the effect of the several variables identified above.[293] In 2013, publicly traded REITs paid out $34 billion in dividends, which includes dividends from all forms of REITs, including those that were formed from spinoffs and those that were not.[294] The first step of the

287. *See* Goolsbee & Maydew, *Organizational Form*, *supra* note 54, at 451.
288. *See id.*
289. *See supra* note 280.
290. *See id.*
291. *See id.*
292. *See supra* text accompanying notes 44 (discussing the distribution requirement), 51–53 (discussing the tax rate).
293. *See supra* Part III.B.
294. *See* REIT.COM, *Industry Data*, http://www.reit.com/investing/

analysis is to deconstruct the $34 billion of REIT dividends to determine what portion is from equity REITs, to estimate the portion and character of equity-REIT dividends, and to identify what portion of REIT taxable income could be from REIT spinoffs. The second step is to estimate how that taxable income would have been taxed if corporations had recognized it. The third step is to estimate how the taxable income was taxed to REIT shareholders. The fourth step is to compare those two results to determine the possible tax-revenue effect of REIT spinoffs. The fifth step is to compare that result with the other publicly available estimates of the aggregate tax-revenue effect of REIT spinoffs.

This analysis adopts the following assumptions from above: (1) the corporate tax rate is 35 percent,[295] (2) the dividend-payout ratio for corporations is 25 percent,[296] (3) individuals directly or indirectly hold 62 percent of corporate stock,[297] (4) the individual corporate shareholder tax rate is 23.8 percent,[298] (5) tax-exempt entities hold 25 percent of the corporate stock,[299] (6) foreign investors hold 13 percent of corporate stock,[300] (7) the foreign investor tax rate on corporate dividends is 15 percent,[301] (8) the effective corporate shareholder tax rate is 16.71 percent,[302] (9) individuals directly or indirectly own 54 percent of REIT stock,[303] (10) the individual REIT shareholder tax rate is 23.8 percent on the capital gain portion of REIT dividends and 43.4 percent on the ordinary income portion of REIT dividends,[304] (11) tax-exempt investors hold 25 percent of REIT stock,[305] (12) foreign investors hold 21 percent REIT stock,[306] (13) the foreign investor tax

industry-data-research/industry-data (last visited Sept. 11, 2014). This analysis excludes dividends paid by non-publicly traded REITs because information about their dividend payments is not publicly available. The estimates from the Joint Committee on Taxation should have included all REITs because the Joint Committee has access to income information of all REITs that file tax returns. Because that estimate is lower than the estimate in this analysis, publicly traded REITs would appear to pay out a majority of REIT dividends.

295. *See supra* text accompanying note 48.

296. *See supra* text accompanying note 45.

297. Individuals directly own 35 percent. *See supra* text accompanying note 182. They indirectly own 27 percent of corporate stock through funds. *See supra* text accompanying note 180.

298. *See supra* text accompanying note 47.

299. *See supra* text accompanying note 174.

300. *See supra* text accompanying note 175.

301. *See supra* text accompanying note 179.

302. *See supra* Table 4.

303. Individuals directly own 35 percent of REIT stock and indirectly own 19 percent. *See supra* text accompanying note 183.

304. *See supra* note 47 and text accompanying note 53, respectively.

305. *See supra* text accompanying note 174.

306. *See supra* text accompanying note 177.

rate on REIT dividends is 15 percent,[307] (14) the effective REIT shareholder tax rate on the ordinary income portion of REIT dividends is 26.59 percent,[308] and (15) the effective REIT shareholder tax rate on the capital gain portion of REIT dividends is 16 percent.[309]

1. *Deconstruction of Publicly-Traded-REIT Dividends*

The $34 billion of REIT dividends in 2013 included dividends from mortgage REITs, which accounted for 9 percent of the REIT market capitalization.[310] Equity REITs therefore accounted for about 91 percent of total REIT market capitalization. Because REIT spinoffs involve equity REITs, the effect of REIT spinoffs should therefore not consider mortgage REITs. Assuming equity REITs and mortgage REITs pay dividends in proportion to their respective market capitalizations, total dividends from equity REITs in 2013 would be about 91 percent of the $34 billion total REIT dividends, or $30.94 billion. The analysis therefore assumes that equity REITs paid $30.94 billion of dividends in 2013.

In 2013, 69 percent of publicly-traded REIT dividends was ordinary income, and 17 percent was long-term capital gains, and the remaining 14 percent was return of capital,[311] so 86 percent of REIT distributions was

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307. *See infra* text accompanying note 179.

308. *See supra* Table 4.

309. The effective REIT shareholder tax rate on the capital gain portion of dividends is computed as follows, using the REIT shareholder composition from above and assuming the individual rate on capital gains is 23.8 percent. *See supra* text accompanying notes 166–184.

Effective Tax Rate of Capital Gain Portion of REIT Dividends			
	Percentage Held by Class	Applicable Tax Rate	Effective Tax Rate
Individuals	35%	23.8%	8.33%
Tax-Exempts	25%	0%	0%
Foreign Investors	21%	15%	3.15%
Funds	19%	23.8%	4.52%
Total Effective Tax Rate			16%

310. At the end of 2013, total REIT market capitalization was $670 billion and mortgage REIT market capitalization was $62 billion. *See* Appendix A.

311. *See* REIT.COM, *Historic Tax Treatment of REIT Common Share Dividends*, http://www.reit.com/investing/industry-data-research/year-end-tax-reporting-data. These figures are consistent with other estimates. *See, e.g.*, Boudry, *Payout Policy*, *supra* note 123, at 612–13 (estimating that from 1997 through 2007, 82 percent of REIT distributions was taxable income, which is slightly less than, but comparable to, the estimate for 2013). To the extent that the return of capital exceeds

taxable income. Consequently, only $26.608 billion of REIT dividends represented taxable income of equity REITs in 2013.[312] Of that amount, $21.349 billion represented ordinary income,[313] and $5.26 billion represented capital gain.[314]

Not all REITs form from corporations through REIT spinoffs or conversions; some form through IPOs by converting from tax partnerships.[315] In fact, REIT spinoffs probably account for a very small percentage of total REITs. Assume, for instance, that only those REITs that account for an increase in the total number of publicly-traded REITs formed since 2001, the year the IRS sanctioned tax-free REIT spinoffs,[316] came into existence through REIT spinoffs.[317] In 2001, there were 151 equity REITs; that number had

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the basis a shareholder has in the REIT stock, the shareholder must recognize capital gain on the distribution, assuming the REIT stock is a capital asset to the shareholder. *See* I.R.C. §301(c)(3). This article assumes that all payments that are a return of capital do not exceed the shareholders' bases in their REIT stock.

312. $30.94 billion of equity REIT dividends × 86%.

313. $30.94 billion of equity REIT dividends × 69%.

314. $30.94 billion of equity REIT dividends × 17%.

315. *See, e.g.*, P.L.R. 2012-04-006 (Oct. 24, 2011) (describing the formation of a REIT to hold an interest in a partnership that holds real estate); P.L.R. 2012-06-001 (Aug. 16, 2011) (describing the formation of a REIT to hold property that appeared to be held in partnership form prior to the acquisition by the REIT); Levitt, *IPO, supra* note 10 (discussing the Empire State Building REIT IPO);, Thomas, *Makes Cents, supra* note 10 (same); *infra* Part IV.C. (discussing partnership-to-REIT formations). In fact, many publicly-traded REITs are so-called UPREITs that form to obtain capital through public markets for umbrella partnerships. *See* Blake D. Rubin et al., *Doing a Deal with a REIT from the Property Owner's Perspective*, 27 J. REAL EST. TAX'N 15 (1999) (describing UPREITs); Brent W. Ambrose & Peter Linneman, *The Maturing of REITs*, 3 WHARTON REAL EST. REV. 37, 40 (1999) (claiming that UPREITs accounted for 77 percent of the REIT equity market capitalization).

316. *See* Rev. Rul. 2001-29, 2001-1 C.B. 1348.

317. This estimate is, of course, very crude because the number of REITs could fluctuate for various reasons. For example, some REITs may have gone out of existence through merger or operating failure, and some undoubtedly formed through IPOs. *See* Sullivan, *Revenue Costs*, *supra* note 282, at 1107–1111 (describing how twenty REITs recently came into existence); Levitt, *IPO, supra* note 10 (discussing the Empire State Building REIT IPO from a tax partnership). Nonetheless, the rough estimate provides a ballpark figure for considering the possible effect of REIT spinoffs, and an estimated ten REITs does not appear to be unreasonable based on the information gathered in Sullivan's study of twenty REITs, of which only a few formed as the result of REIT spinoffs or corporate conversions. *See* Sullivan, *Revenue Costs*, *supra* note 282.*See id.* In fact, Sullivan appears to analyze the revenue effect of REITs that converted from partnerships using the same methods he used to analyze REITs that converted from corporations. *See, e.g.*, *id.* at 1107 (including in his analysis Plum Creek Timber Co. Inc., which converted from a master limited partnership (i.e.,

grown to 161 in 2013.[318] Thus, a net of ten new publicly-traded equity REITs have formed since 2001, which is 6.62 percent of the 151 equity REITs in 2001. This analysis therefore assumes that only 6.62 percent of total REITs in 2013 formed through REIT spinoffs. Consequently, the analysis assumes that only $2.048 billion of the $30.94 billion of 2013 REIT dividends were paid by REITs that were formed from corporations. Next, the analysis determines the composition of the $2.048 billion of dividends from REIT spinoffs.

Assuming that 2013 dividends from spun-off REITs was $2.048 billion, the ordinary income portion of those dividends would have been $1.413 billion,[319] the capital gain portion would have been $348 million,[320] and the return-of-capital portion would have been $287 million.[321] Thus, the $2.048 billion of REIT dividends represents $1.851 billion of taxable income.[322] Table 7 summarizes the estimated composition of the 2013 dividends from spun-off REITs.

Table 7: Deconstructed 2013 REIT Dividends	
Total 2013 REIT Dividends	$34,000,000,000
Portion Attributable to Equity REITs (91%)	$30,940,000,000
Dividends Attributable to Equity REITs	
Portion of Equity REIT Divided Representing Taxable Income (86%)	$26,608,000,000
Ordinary Income Portion (69%) of Equity REIT Dividends	$21,349,000,000
Capital Gain Portion (17%) of Equity REIT Dividends	$ 5,260,000,000
Return of Capital Portion (14%) of Equity REIT Dividends	$ 4,332,000,000
Dividends Attributable to REIT Spinoffs	
Portion of Equity-REIT Dividends Attributable to REIT Spinoffs (6.62%)	$ 2,048,000,000
Ordinary Income Portion (69%) of Spun-Off REIT Dividends	$ 1,413,000,000
Capital Gain Portion (17%) of Spun-Off REIT Dividends	$ 348,000,000
Return of Capital Portion (14%) of Spun-Off REIT Dividends	$ 287,000,000
Taxable Income Portion (86%) of Spun-Off REIT Dividends	$1,761,000,000

publicly traded tax partnership, *see infra* text accompanying note 354) and then elected to be a REIT).

318. *See* Appendix A.
319. $2.048 billion × 69%.
320. $2.048 billion × 17%.
321. $2.048 billion × 14%.
322. $1.413 billion ordinary income + $348 million capital gain.

2. *Aggregate Consequences if No REIT Spinoffs*

The $1.761 billion portion of spun-off REIT dividends that are taxable represents the maximum amount that could have been subject to corporate tax, if the REITs had not been spun off and the income had been recognized by corporations instead.[323] That $1.761 billion estimate therefore represents the corporate-tax-base erosion (i.e., taxable income that otherwise would have been subject to corporate tax) from REIT spinoffs in 2013.[324] If corporations had recognized that $1.761 billion of taxable income, they would have paid $616 million of tax at the 35 percent tax rate.[325] Assuming a 25 percent dividend-payout ratio, the corporations would have distributed $440 million to their shareholders. The shareholders would have paid about $74 million of tax on that distribution, assuming a 16.71 percent effective corporate shareholder tax rate.[326] Thus, the total tax liability on the $1.761 billion of taxable income would have been $690 million if the REIT spinoffs had not occurred.

3. *Aggregate Consequences with REIT Spinoffs*

The $1.761 billion of taxable income flowed through to REIT shareholders as $1.413 billion of ordinary income and $348 million of capital gain.[327] Assuming an effective tax rate of 26.59 percent on the ordinary income portion of the REIT dividends,[328] the tax on the $1.413 billion of those dividends would have been $376 million.[329] Assuming a 16 percent effective tax rate on the $348 million capital gain portion of the REIT dividends,[330] the tax on that portion would have been about $56 million.[331] Consequently, the total tax paid by REIT shareholders on dividends from presumed REIT

323. *See supra* text accompanying notes 75–86 (describing how a REIT spinoff erodes the corporate tax base).

324. The corporate income erosion equals 86 percent (69 percent ordinary income + 17 percent capital gain) of the total dividends attributable to REIT taxable income. *See supra* text accompanying note 311.

325. Appendix D includes a more in-depth presentation of the calculation related to the aggregate tax-revenue effect of 2013 REIT dividends. Slight differences between the numbers in the appendix and the numbers in this analysis are attributable to rounding.

326. *See supra* Table 4.

327. *See supra* text accompanying notes 319–320.

328. *See supra* Table 4.

329. $1.413 billion ordinary income dividends × 26.59%.

330. *See supra* note 309.

331. $348 million capital gain dividends × 16%.

spinoffs would have been $432 million.[332] Thus, the tax liability with the REIT spinoff is almost 63 percent of what the tax liability would be without the spinoff.[333]

4. *Aggregate Overall Effect of REIT Spinoffs*

This analysis suggests that REIT spinoffs eroded the corporate tax base by $1.761 billion and decreased corporate tax revenue by $616 million, but they accounted for only $258 million of lost tax revenue in 2013.[334] This estimate differs from other estimates of the tax-revenue effect of REIT spinoffs, but those differences can be explained. The $258 million estimate takes into account the overall effect of REIT spinoffs, whereas Sullivan's estimate appears to only account for lost corporate tax revenue.[335] The $616 million of lost corporate tax revenue is therefore closer to Sullivan's $900 million low-end estimate of REIT spinoffs and conversions. Sullivan's estimate would, of course, be higher than the estimate from this dynamic analysis because his estimate considers both REIT spinoffs and other REIT formations, which actually may not erode the corporate tax base.[336]

This dynamic estimate is slightly less than the Joint Committee's average annual lost revenue, but is very close to the $200 million tax-revenue loss from REIT spinoffs that it estimated for 2014.[337] The similarity between the two estimates reflects the results of dynamic analyses that this analysis and the Joint Committee employ in computing the tax-revenue effect of REIT spinoffs. The Joint Committee has access to precise information about the number and size of REIT spinoffs and REIT shareholders. They also use complex models that account for other proposed changes in the Camp Proposal.[338] Nonetheless, similarity suggests that the rough estimates used in this analysis reflect reality.

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332. $376 million on ordinary income + $56 million on capital gain.

333. $432 million tax liability with the spinoff ÷ $690 million tax liability without the spinoff.

334. $690 million tax assuming no REIT spinoffs – $432 million tax with REIT spinoffs.

335. *See* Sullivan, *Revenue Costs*, *supra* note 282, at 1103 ("This article presents various estimates of the long-term entity-level tax savings that 20 corporations gain from electing REIT status."). Sullivan considers REIT dividend distributions to estimate the amount of REIT taxable income that would be subject to corporate income tax, but for REIT formation; he does not appear to consider the tax effect of the higher tax rate on REIT dividends. *See id.* at 1105–07.

336. *See infra* Part IV.D. (discussing the effect of partnership-to-REIT formations).

337. *See* JOINT COMM., ESTIMATED EFFECTS, *supra* note 278, at 10.

338. *See* Sunley & Weiss, *Estimating Process*, *supra* note 279.

The $258 million estimated tax-revenue effect in this analysis is significantly less than the $2.6 billion from the 2002 study.[339] That difference could be largely attributable to the different points of analysis. That analysis focused on the potential lost tax-revenue that would result from corporations in the largest industries spinning off real estate assets.[340] The analysis in this article focuses solely on the cost of previous spinoffs. The potential tax cost of spinoffs is undoubtedly greater than the actual cost.

Finally, consider the significance of the results in the context of government receipts. The $258 million of lost tax revenue is 0.0093 percent of the $2.775 trillion of total government revenue in 2013.[341] The $616 million of lost corporate tax revenue is just 0.2254 percent of $274 billion of 2013 corporate tax revenue.[342] This analysis shows that REIT spinoffs do not have a significant effect on corporate tax revenue, and the effect on overall government receipts is miniscule. The following analysis shows that tax revenue lost from REIT spinoffs is, in fact, significantly less than the loss from property owners forming REITs instead of owning property in partnerships. This is another counterintuitive result of the dynamic analysis of REIT taxation.

C. *Tax-Revenue Effect of Partnership-to-REIT Formations*

Intuition suggests that REITs would have a significant effect on tax revenue because they are not subject to an entity-level tax and therefore erode the corporate tax base. It is counterintuitive to think that REITs could affect tax revenue by taking taxable income from partnerships because REITs are conduit entities and partnerships are flow-through entities. Because neither REITs nor partnerships pay an entity-level tax, it is counterintuitive to think forming one instead of the other could significantly affect tax revenue. Nonetheless, many real estate ventures that are REITs would not be corporations if they were not REITs. Instead, many would likely be partnerships.[343] Therefore, the analysis of the tax-revenue effect of REIT

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339. *See supra* text accompanying notes 287–288.

340. *See* Goolsbee & Maydew, *Organizational Form*, *supra* note 54, at 451.

341. *See supra* text accompanying note 280. $258 million lost tax revenue ÷ $2.775 trillion total 2013 government receipts.

342. *See id.* $258 million lost tax revenue ÷ $274 billion total 2013 corporate tax revenue.

343. *See supra* text accompanying notes 55–61 (explaining some general aspects of partnership taxation); *infra* text accompanying notes 353–355 (comparing REITs to publicly traded partnerships in very general terms). Another alternative to investing in REITs is simply not investing in U.S. real estate. For the sake of analysis, this Article assumes that all current REIT investors would otherwise invest in real estate through a corporation or a partnership. If those investors would not otherwise invest in real estate, the lost investment would be a non-tax cost of limiting the scope

taxation must account for REITs that would otherwise be partnerships and consider the tax-revenue effect of that alternative. For various reasons, real estate owners often prefer to hold real estate in partnerships instead of in REITs, especially if the partnership is closely held.[344] For example, partnerships can have as few as two members,[345] but REITs must have at least 100 shareholders.[346] REIT liability does not increase the basis shareholders have in their REIT stock, but partnership liability increases the basis partners have in their partnership interests.[347] That higher basis allows partnerships to pass operating losses through to partners who can use the losses to offset income from other sources.[348] Recall that REITs cannot pass net losses through to their shareholders.[349]

Unlike partnerships,[350] REITs do not have any leeway in allocating tax items to shareholders. REITs must distribute dividends pro rata among shareholders that hold the same class of stock.[351] The REIT shareholders must include REIT distributions in gross income to the extent that they represent taxable income of the REIT.[352] Partnerships, on the other hand, have significant leeway in allocating tax items to partners as long as the allocations

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of REIT taxation. Taking into account the non-investment alternative should also reduce the tax-revenue effect of REIT taxation because the government would not appear to lose tax revenue by facilitating an investment that otherwise would not occur. Consequently, the analysis of REITs forming from partnerships returns an estimate of the tax-revenue effect that is most likely greater than the effect would be if it accounted for the non-investment alternative.

344. *See supra* text accompanying notes 51–63 (discussing general aspects of REIT and partnership taxation).

345. *See* Reg. § 301.7701-3(a) (providing than an eligible entity with at least two members can be a partnership).

346. *See* I.R.C. § 856(a)(5).

347. *See* I.R.C. §§ 705, 721, 722, 752.

348. *See* I.R.C. §§ 702, 703. A partner can only deduct such losses, however, to the extent the losses do not exceed the partner's basis in the interest in the partnership and are not subject to the passive activity loss or at-risk rules. *See* I.R.C. § 465 (limiting deductions to the amount at-risk); I.R.C. § 469 (limiting the deductibility of losses from passive activity); I.R.C. § 704(d) (limiting losses to the amount of the partner's basis in the partnership interest); Borden et al., *A Model for Measuring the Expected Value of Assuming Tax-Partnership Liability*, 7 BROOK. J. CORP., FIN. & COM. L. 361, 364–71 (2013).

349. *See supra* text accompanying note 62.

350. *See supra* text accompanying note 43.

351. *See* I.R.C. § 857(b)(2)(B) (allowing a deduction for dividends paid defined in I.R.C. § 561); I.R.C. § 561(b) (referring to the rules in I.R.C. § 562 to define dividends); I.R.C. § 562(c) (requiring dividends to be pro rata within each class of stock); Reg. § 1.562-2 (discussing pro rata distributions); P.L.R. 2013-16-013 (Jan. 16, 2013) (applying these rules to a REIT).

352. *See supra* text accompanying note 42.

are in accordance with the partners' interests in the partnership or have substantial economic effect.[353] Thus, many property owners prefer to own property through partnerships instead of through REITs. In fact, publicly traded partnerships can hold real estate and provide to their members the benefits generally afforded closely-held partnerships.[354] Consequently, owning real estate through a publicly traded partnership is also an alternative to REIT ownership, but publicly traded partnerships cannot provide the same level of services that a REIT can provide.[355] Consequently, REITs also provide an operational advantage over publicly traded partnerships.

Despite the perceived advantages of owning real estate through partnerships, REITs come into existence from arrangements that might otherwise be partnerships. Access to public capital through an arrangement that is not subject to the publicly-traded partnership rules and the preference of foreign and tax-exempt investors for REITs explain why some investors choose REITs over partnerships.[356] REITs that would otherwise be partnerships do not erode the corporate tax base, unless there is some indication that they would have formed as corporations instead of remaining partnerships, if the REIT alternative did not exist. Because information about that decision process does not appear to be available, this analysis assumes that all REITs that are not assumed to form from REIT spinoffs form from partnerships.

REIT ownership provides tax advantages to foreign investors in U.S. real estate that they cannot obtain by owning real estate directly or through a partnership.[357] Foreign investors must consider both the tax on rental income from property and gain from the disposition of property when considering the appropriate real estate investment vehicle. If a foreign investor owns U.S. real estate directly or through a partnership, the tax treatment of the investment turns on whether the foreign investor is treated as engaged in a U.S. trade or

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353. *See* I.R.C. § 704(a), (b); *supra* text accompanying note 43.

354. Publicly traded partnerships are generally treated as corporations, but if most of their income derives from passive sources, including rent from real property, they can qualify for partnership flow-through taxation. *See* I.R.C. § 7704(a), (b), (c), (d).

355. *See* Borden, *Reforming REIT Taxation*, *supra* note 15 (discussing the services that a REIT can provide directly and through a taxable REIT subsidiary and the limited services that a publicly traded partnership can provide).

356. Foreign investors go to great lengths to ensure that income from U.S. sources is of a preferred character. *See, e.g.*, Willard B. Taylor, *"Blockers," "Stoppers," and the Entity Classification Rules*, 64 TAX LAW. 1 (2010) (describing structures that foreign investors use to obtain favorable tax treatment).

357. For a comprehensive coverage of the tax aspects of foreign investment in U.S. real estate, see Austrian & Schneider, *Tax Aspects*, *supra* note 32.

business by reason of such investment.[358] If the foreign investor is not treated as engaged in a U.S. trade or business by reason of such investment, then the gross rental income (i.e., rental income without the allowance for depreciation or other deductions related to the property) of the property is subject to a 30 percent withholding tax.[359] A treaty could reduce that rate, but most U.S. income tax treaties do not provide for a reduced rate of tax on rents from U.S. real property.[360] If the foreign investor is treated as engaged in a U.S. trade or business with respect to the property, the investor must file a U.S. tax return,[361] pay tax at the ordinary tax rates that apply to taxable income of U.S. persons,[362] and may take deductions against the gross rental income of the property.[363]

Foreign investors are also subject to tax under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) on any gains recognized on the disposition of a U.S. real property interest.[364] FIRPTA treats gain recognized by a foreign investor from the sale of a U.S. real property interest as gain effectively connected to a U.S. trade or business.[365] Consequently, the ordinary tax rates apply to such gain and the foreign person is required to file a U.S. tax return.[366] Furthermore, the person acquiring a U.S. real property interest from a foreign person is required to withhold 10% of the amount realized (i.e., the

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358. *See* Staffaroni, *Foreign Investors*, *supra* note 20, at 545–47. This Article uses the term "foreign investor" to refer to nonresident alien individuals and foreign corporations. *See supra* note 165.

359. *See* I.R.C. §§ 871(a)(1)(A), 881(a).

360. *See* Michael J. Caballero et al., *U.S. Taxation of Foreign Investment in U.S. Real Estate*, 912-2d TAX MGMT. PORT. (BNA) § II.C (2015).

361. *See* I.R.C. §§ 874(a), 882(c)(2) (requiring foreign investors who engage in a U.S. trade or business to file a U.S. tax return to claim allowed deductions).

362. *See* I.R.C. §§ 871(b), 882(a) (imposing the ordinary tax rates on the taxable income of foreign investors engaged in a U.S. trade or business).

363. *See* I.R.C. §§ 873(a), 882(c)(1) (allowing deductions for costs effectively connected to a U.S. trade or business). Foreign corporations could also be subject to a branch profits tax on income effectively connected to the United States, which tax can be as high as thirty percent. *See* I.R.C. § 884(a).

364. *See* I.R.C. § 897(a); Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, § 1122(a), 94 Stat. 2599, 2682. *See also* Willard B. Taylor, *Suppose FIRPTA Was Repealed*, 14 FLA. TAX REV. 1 (2013) (discussing various aspects of FIRPTA); Richard M. Lipton & Patricia W. McDonald, *Foreign Investment in U.S. Real Estate: The FATCA/FIRPTA Dichotomy*, 120 J. TAX'N 248 (2014) [hereinafter Lipton & McDonald, *Dichotomy*] (discussing the application of FIRPTA to various forms of real property ownership). All references herein to FIRPTA are to the law as currently enacted, unless provided otherwise.

365. *See* I.R.C. § 897(a).

366. *See* I.R.C. § 897(a)(1)(A) (applying the general non-U.S. individual tax rules to FIRPTA gains); I.R.C. § 897(a)(1)(B) (applying the general non-U.S. corporate tax rules to FIRPTA gains); *supra* note 363 (providing for the tax on foreign investors).

amount paid for the property) on the sale.[367] Exemptions in U.S. tax treaties for capital gain realized by foreign investors generally do not apply to gains taxable under FIRPTA.[368]

The tax treatment of foreign investors in U.S. partnerships turns on the activities of the partnership.[369] For foreign investors in U.S. partnerships that own real estate, if the partnership is considered to be engaged in a U.S. trade or business, the members of the partnership are considered to be engaged in a U.S. trade or business.[370] Thus, foreign members of U.S. partnerships that engage in a trade or business with respect to real property must file a tax return and pay tax on their shares of the partnership's income at ordinary U.S. income tax rates.[371] Allocations to foreign members of U.S. partnerships of gain from the sale of a U.S. real property interest would also be subject to the FIRPTA rules with some modifications.[372] A partnership is required to withhold 35 percent of the gain (instead of 10 percent of amount realized) from the sale of a U.S. real property allocated to a foreign member of the partnership.[373] Gains recognized by a foreign member of a U.S. partnership on the sale of an interest in a partnership are also subject to FIRPTA to the extent they represent U.S. real property interests.[374] Finally, partnerships engaged in a U.S. trade or business must withhold tax on income allocated to foreign members of U.S.

367. *See* I.R.C. § 1445(a). The amount realized is roughly equal to the property's sales price. *See* I.R.C. § 1001(b) (defining amount realized as the sum of money received by the seller plus the fair market value of any property the seller receives as consideration).

368. Congress intended FIRPTA to override any contrary provisions in treaties after December 31, 1984. *See* Pub. L. No. 96-499, § 1125(c), 94 Stat. 2599, 2681 (1980), *amended by* Pub. L. No. 97-34, § 831(h), 95 Stat. 172, 352 (1981); Staffaroni, *Foreign Investors*, *supra* note 20, at 563–64.

369. *See* I.R.C. § 875(1). A partnership is any entity that is treated as a partnership for tax purposes, which generally includes partnerships, limited partnerships, and limited liability companies. *See* Reg. § 301.7701-1 to -3.

370. *See* I.R.C. § 875(1).

371. *See supra* text accompanying note 363.

372. *See* Lipton & McDonald, *Dichotomy*, *supra* note 364, at 256–57.

373. *See* I.R.C. § 1445(e)(1).

374. *See* I.R.C. § 897(g). For purposes of the withholding tax, the interest in a U.S. tax partnership is treated as a U.S. real property interest in its entirety if at least 50 percent of the tax partnership's assets are U.S. real property interests and at least 90 percent are U.S. real property interests or cash or cash equivalents. *See* Reg. § 1.897-7T(a).) The rules also treat publicly traded tax partnerships as corporations for purposes of applying FIRPTA to dispositions of interests in publicly traded tax partnerships. *See* Reg. § 1.897-1(c)(2)(iv). Consequently, FIRPTA would apply to the sale of such an interest only if the foreign investor holds greater than 5 percent of the interests in the tax partnership. *See id.*; *infra* text accompanying note 386.

partnerships at the highest applicable ordinary income tax rate.[375] Contrast that treatment to the treatment afforded a foreign investor in a REIT that holds U.S. real property.

A foreign investor in a U.S. REIT generally is not treated as engaged in a trade or business with respect to REIT stock or the property of a REIT by virtue of holding REIT stock.[376] Consequently, a foreign investor in a U.S. REIT generally is not required to file a U.S. tax return simply because it holds REIT stock.[377] A foreign investor only has to file a U.S. tax return with respect to distributions from a REIT if the gains are out of gain from the sale of U.S. real property.[378] Ordinary dividends from a REIT can qualify for lower rates under tax treaties.[379] The tax rate on those dividends can range from a low of 5 percent to 15 percent under older treaties, and 15 percent under more recent treaties if the foreign investor holds less than a 10 percent interest in the REIT (i.e., the REIT is domestically controlled).[380] Otherwise the rate is 30 percent.[381] REIT dividends approximately equal a REIT's taxable income,[382] so they reflect deductions at the REIT level.[383] Thus, a REIT dividend, even one subject to the 30 percent rate, is not based upon gross rent. These differences make investments in REITs more attractive to foreign investors than direct investment or investment in U.S. real estate through a partnership. Foreign investors must, however, be aware that REIT capital-gain dividends are subject to a 35 percent withholding rate.[384]

Stock in a REIT can be treated as a U.S. real property interest for FIRPTA withholding purposes,[385] but if REIT stock is publicly traded and the foreign person owns less than 5 percent of the stock for the five-year period preceding the disposition, the REIT stock would not be a U.S. real property

375. *See* I.R.C. § 1446(a); Reg. § 1.1446-3(a)(2)(i). If the tax partnership is publicly traded, however, the withholding rules only apply if the tax partnership makes distributions. *See* Reg. § 1.1446-4(a).

376. *See* I.R.C. §§ 871(a)(1)(A), 881(a)(1) (providing for the tax treatment of dividends not connected to a U.S. trade or business); Michael Hirschfeld & Shaul Grossman, *Opportunities for the Foreign Investor in U.S. Real Estate—If Planning Comes First*, 94 J. TAX'N 36, 47 (2001).

377. *See* Hirschfeld & Grossman, *Opportunities*, *supra* note 376; *supra* text accompanying notes 358–363.

378. *See* I.R.C. § 897(a)(1) (h)(1); *supra* note 362.

379. *See* Staffaroni, *Foreign Investors*, *supra* note 20 at 548–51.

380. *See id.* at 548–49; U.S. Model Tax Convention, *supra* note 179, at art. 10(2).

381. *See* I.R.C. § 871(a)(1)(A).

382. *See supra* note 123 (providing that REIT dividends actually exceed REIT taxable income on average).

383. *See* I.R.C. § 857(b)(2)(B).

384. *See* Reg. § 1.1445-8(c)(2).

385. *See* I.R.C. § 897(c)(1)(A)(ii) (defining U.S. real property interest generally to include any interest in a U.S. corporation).

interest.[386] The stock of a REIT is also excluded from the definition of U.S. real property interest for FIRPTA purposes if the REIT is a domestically-controlled entity.[387] A REIT is domestically controlled if foreign investors own less than 50 percent of the REIT stock at all times during the five years preceding the sale.[388] Private REITs generally must ensure that they are domestically controlled to avoid causing foreign investors to lose treaty benefits; otherwise, foreign investors will simply acquire interests in publicly traded REITs.[389] Consequently, foreign investors, especially those in treaty countries, would normally prefer holding REIT stock as opposed to direct ownership in U.S. real estate or indirect ownership through a partnership. That preference undoubtedly results in the formation of many REITs that otherwise would be formed as partnerships. Such REITs do not erode the corporate tax base, but they could reduce overall tax revenue by eroding the partnership tax base.

Because owning real property in REITs provides a tax break for foreign investors, REITs reduce the tax revenue that the government would otherwise collect from real estate owned by foreign investors. To illustrate the tax-revenue effect of a foreign investment in a REIT versus the same investment in a partnership, an example makes the following assumptions: (1) the property in question is located in the United States and is worth $500 million; (2) the property is owned by either a REIT or a partnership; (3) less than 50 percent of the REIT or partnership is owned by foreign investors, so the REIT is a domestically-controlled REIT;[390] (4) the investor in question owns slightly less than 10 percent of the entity, so the treaty provides a 15 percent rate for its REIT dividend income;[391] (5) the gross rent revenue from the property is $40 million; (6) the annual depreciation deduction for the property is $11.5 million; and (7) the annual operating expenses, including interest deductions, are $18 million. The property will therefore have $10.5 million of taxable income, of which $1.05 million will be allocated to the foreign investor.

Consider the tax consequences summarized in Table 8 if (1) a partnership owns the property and is not engaged in a trade or business with respect to the property, (2) a partnership owns the property and is engaged in a trade or business with respect to the property, and (3) a REIT owns the property. If the owner is a partnership not engaged in a trade or business in the United States with respect to the property, the investor would not be required

386. *See* I.R.C. § 897(c)(3).

387. *See* I.R.C. §§ 897(h)(2); 897(h)(4)(A)(i)(I).

388. *See* I.R.C. § 897(h)(4)(B), (D).

389. *See* Willys H. Schneider, *U.S. Tax Rules Affecting Foreign Investors in REITs*, 24 REAL EST. TAX'N 40, 47–48 (1996).

390. *See supra* text accompanying note 388.

391. *See supra* text accompanying notes 179, 380.

to file a U.S. tax return, the tax base for computing the foreign investor's U.S. tax liability would be 10 percent of the $40 million gross rent, and the partnership would have to withhold tax on gross rent allocated to the foreign investor at the 30 percent rate.[392] The foreign investor would therefore owe $1.2 million of U.S. tax with respect to the property. If the foreign investor owns an interest in a partnership that is engaged in a trade or business with respect to the property, the investor would have to file a U.S. tax return, the investor's tax base would be 10 percent of the partnership's $10.5 million taxable income, or $1.05 million, and the investor would pay tax on that amount at 43.4 percent.[393] The foreign investor's U.S. tax liability with respect to the property would therefore be $0.456 million under this scenario.[394] Finally, if the foreign investor acquired REIT stock, the investor would not have to file a U.S. tax return.[395] The investor's tax base would be the $1.05 million REIT dividend stemming from 10 percent of the REIT's taxable income, and the investor's tax rate would be 15 percent.[396] Consequently, under this scenario, the foreign investor's tax liability would be $157,500.[397]

Table 8: Taxation of Foreign Investment in U.S. Real Property

	Partnership Not Engaged in Trade or Business	**Partnership Engaged in Trade or Business**	**REIT**
File a Tax Return?	No	Yes	No
Tax Base	Share of Gross rent	Share of Ordinary Taxable Income	Share of Ordinary Taxable Income
Investor's 10% Share of Tax Base	$4,000,000	$1,050,000	$1,050,000
Tax Rate	30%	43.4%	15%
Tax Liability	$1,200,000	$ 455,700	$ 157,500
Percent of $455,700	263%	100%	35%

Because foreign investors would pay just 35 percent of the tax they would otherwise owe if they owned property through a REIT, they will often

392. *See supra* text accompanying notes 369–375.
393. *See supra* text accompanying note 53, 369–375.
394. $1.05 million income × 43.4%.
395. *See supra* note 377.
396. *See supra* text accompanying note 380.
397. $1.05 million income × 15%.

prefer a REIT investment. Consequently, REITs can erode the partnership tax base and decrease tax revenue because foreign investors choose REITs over partnerships. Because the tax liability of a foreign investor in a U.S. REIT could be less than 35 percent of the tax liability from the same property held by a U.S. partnership, the tax-revenue-effect of REITs eroding the partnership tax base would appear to be greater than the tax-revenue effect of REITs eroding the corporate tax base. Recall that the tax liability with the REIT spinoff was 40 percent of the tax liability without a spinoff.[398] Because the tax liability of a foreign investor in a REIT is just 35 percent of the tax liability of the same investment in a partnership, the overall tax-revenue effect of foreign investors choosing REIT investments over partnership investments should be greater than the overall tax-revenue effect of investors choosing REITs over corporations.

Tax-exempt entities also prefer owning real estate through a REIT over direct ownership or ownership through a partnership.[399] Tax-exempt entities are exempt from tax on REIT dividends and are not treated as engaged in the activities of the REIT.[400] Rents for real property paid directly to tax-exempt entities are also exempt from tax.[401] If, however, such rents are from debt-financed property, they are unrelated business taxable income and taxable to the tax-exempt investor.[402] A partnership's debt-financed income would flow through to a tax-exempt investor and be subject to the unrelated business income tax.[403] If a REIT has debt-financed income, that income generally would not flow through to the tax-exempt investor, so the dividends from the REIT would not be subject to unrelated business income tax.[404] Thus, REITs can provide a benefit to tax-exempt investors.

398. *See supra* text accompanying note 333.

399. *See* STAFF OF JOINT COMM. ON TAXATION, 113TH, CONG., TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE III—BUSINESS TAX REFORM, JCX-14-14, p. 265 (Comm. Print 2014).

400. *See* Rev. Rul. 66-106, 1966-1 C.B. 151 (ruling with respect to a tax-exempt pension trust that held REIT stock).

401. *See* I.R.C. § 512(b)(3) (exempting rent from unrelated business taxable income).

402. *See* I.R.C. § 512(b)(4).

403. *See* I.R.C. § 512(c)(1).

404. *See* I.R.C. § 512(b)(1) (exempting dividends from unrelated business taxable income). A tax-exempt investor in REITs generally would not recognize debt-financed rent as dividends received from a REIT, but it could if it were a pension trust that owned more than 10 percent of a pension-held REIT. *See* I.R.C. § 856(h)(3)(C). *See* Borden, *Reforming REIT Taxation*, *supra* note 15 (describing the consequences of owning stock in a pension-held REIT).

The tax-revenue effect of tax-exempt REIT ownership in this context would depend upon the portion of dividends that tax-exempt investors receive from REITs that would otherwise be debt-financed income. This analysis uses the 34.1 percent debt ratio of publicly traded equity REITs as a proxy for the amount of debt-financed income that REITs allocate to tax-exempt entities.[405] The income allocated to the tax-exempt investors from REITs is not subject to tax, but the analysis assumes that if partnerships had allocated the same amount of income to tax-exempt investors that they would be subject to the 35 percent tax rate.[406] As with foreign investment, the effect of tax-exempt investment in REITs instead of partnerships could be significant because of the rate differential that applies to the two different types of investment.

1. *Estimated Partnership-to-REIT Formations*

Recall that foreign investors appeared to hold as much as 21 percent of REIT stock in 2013.[407] To begin the analysis of the tax-revenue effect of that holding, assume that all publicly-traded REITs are domestically-controlled REITs, that no foreign investor owns more than 10 percent of any single REIT, and that all REITs would be partnerships, if they had not formed as REITs or formed through REIT spinoffs. As shown above, in 2013, publicly traded equity REITs had approximately $26.608 billion of taxable income,[408] of which $21.349 billion was ordinary income and approximately $5.26 billion was capital gains.[409] The analysis above assumed that 6.62 percent of REITs formed from spinoffs,[410] so continuing that assumption, not more than 93.38 percent of REITs could have formed from partnerships. Based upon that assumption, not more than $24.847 billion, or 93.38 percent of the $26.608 billion, of taxable income could be from REITs that otherwise would have been partnerships. This analysis therefore assumes that $24.847 billion represents the amount by which REITs eroded the partnership tax base. The analysis next considers how foreign ownership of REITs and that partnership-tax-base erosion affects tax revenue.

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405. *See* Ron Kuykendall, REIT.COM, *REITs Raised Record Amount of Capital in 2013* (Jan. 15, 2014), https://www.reit.com/news/articles/reits-raised-record-amount-capital-2013.

406. *See* I.R.C. § 11(b)(1)(D) (imposing a maximum tax rate of 35 percent on corporate income); I.R.C. § 511(a)(1) (imposing the ordinary corporate tax rate on unrelated business taxable income).

407. *See supra* text accompanying notes 176–177.

408. *See supra* text accompanying note 312.

409. *See supra* text accompanying notes 313–314.

410. *See supra* text immediately following note 318.

2. *Consequences if No REIT Formation*

To avoid unwieldy complexity, this analysis assumes that the allocation of tax items would remain the same whether an arrangement were a partnership or a REIT and that amounts allocated to U.S. individuals are taxed the same regardless of the form of ownership. The amounts of taxable income allocated to those partners should generally be taxed the same whether coming from a partnership or a REIT,[411] so the tax-revenue effect of a partnership-to-REIT formation focuses on the treatment of income flowing to foreign and tax-exempt investors.

Of the $24.847 billion of estimated partnership-tax-base erosion, only 21 percent, or $5.218 billion, would have flowed through to foreign investors, assuming they would have held the same 21 percent interest in both partnerships and REITs.[412] Of that $5.218 billion partnership tax base allocated to foreign investors, $3.6 billion would have been from ordinary income[413] and $887 million would have been from capital gains.[414] If that income had flowed through to foreign members of a U.S. partnership, the $3.6 billion of ordinary

411. Partnerships and REITs are subject to different tax regimes. *See supra* text accompanying notes 51–63. Those different regimes do not, however, necessarily affect the character of income that flows to the members of the respective arrangements, assuming that the respective entities are able to allocate tax items similarly.

412. Because partnerships generally are not publicly traded, information about the percentage of foreign ownership in partnerships is not publicly available. This analysis assumes the percentage is the same as that for REITs, which is a conservative assumption. Because REITs provide more favorable tax treatment for foreign investors, foreign ownership of REITs should be greater than it is of partnerships. Because the capital gains allocated from either type of arrangement to foreign investors is taxed at 35 percent, if the foreign investors held less than 21 percent of the interests of converting partnerships, a larger percentage of the capital gain income from partnerships would be taxed at the favorable 23.8 percent rate. If taxed at the higher rate when flowing to foreign members of a REIT, it would generate more tax revenue and offset the amount lost due to the favorable treatment of ordinary REIT dividends. Thus, assuming 21 percent foreign ownership of partnerships would appear to overstate the amount of tax revenue that is lost from partnership to REIT formations. The 21 percent assumption therefore may overstate the foreign investment in partnerships, but appears to be a fairly accurate assumption about foreign ownership of REITs. *See supra* text accompanying note 177.

413. $5.218 billion of income allocated to foreign investors × 69% ordinary income portion of REIT dividend. *See supra* text accompanying note 311.

414. $5.218 billion of income allocated to foreign investors × 17% capital gain portion of REIT dividend. *See id.*

income would have been taxed at 43.4 percent,[415] and the $887 million of capital gain would have been taxed at 35 percent.[416] The total tax liability for foreign partners at those rates would have been approximately $1.872 billion,[417] for an effective tax rate of almost 42 percent.[418]

Of the $24.847 billion of estimated partnership-tax-base erosion, only 25 percent, or $6.212 billion, would have flowed through to tax-exempt investors, assuming they would have held the same 25 percent interest in both partnerships and REITs.[419] Of the $6.212 billion, 34.1 percent,[420] or $2.118 billion, represents debt-financed income. Tax-exempt investors would owe tax on that amount at the normal 35 percent corporate rate,[421] so they would owe about $741 million of tax on the income, if partnerships had allocated the $2.118 billion to them.[422] The total tax that foreign and tax exempt investors would have paid, had a partnership allocated the income to them, would have been $2.613 billion.[423]

3. *Consequences with REIT Formations*

Assuming that all of the foreign investors are in treaty countries and pay tax on ordinary REIT dividends at 15 percent,[424] the tax rate on the $3.6

415. *See supra* text accompanying notes 51–53 (explaining the tax rates); text accompanying notes 358–375 (providing that foreign investors are generally subject to the normal tax rates if they are engaged in a U.S. trade or business).

416. *See supra* text accompanying note 373.

417. The $1.872 billion total tax liabilities of partners would have been the sum of $1.562 billion ($3.6 billion × 43.4%) and $310 million ($887 million × 35%).

418. $1.872 billion foreign investor tax liability ÷ $4.487 income deemed allocated to foreign investor.

419. As with foreign ownership, the preferential tax treatment that REITs provide undoubtedly affects the level of investment in REITs as compared to the level of investment in partnerships. Nonetheless, for simplicity's sake, this analysis assumes that tax-exempt investors would hold the same 25 percent share of partnership interests, if they were not able to invest in REITs. *See supra* text accompanying notes 173–174.

420. *See supra* text accompanying note 405.

421. *See supra* text accompanying note 406.

422. $2.118 billion × 35%.

423. $1.872 billion paid by foreign investors + $741 million paid by tax-exempt investors.

424. Not all foreign investors necessarily qualify for favorable treaty dividend rates, but information that is generally publicly available does not appear to distinguish between such foreign investors. In fact, a lengthy study of foreign investment considers only certain investors from sixteen countries. Of those countries, only some provided the most favorable tax rate, but the information does not appear to be sufficient to determine what the overall treaty tax rate would be. *See* Margot Howard, et al., *The Impact of Foreign Withholding Taxes on REIT Investors and*

billion of ordinary income portion of the REIT dividends would be 15 percent,[425] and the tax rate on the $887 million of capital gain portion of the REIT dividends allocated to foreign investors would be 35 percent.[426] Foreign investors therefore paid approximately $850 million of tax on REIT income allocated to them.[427] The effective tax rate on the $4.487 billion allocated to foreign investors would be about 19 percent.[428] Tax-exempt investors would have paid no tax on the dividends they received from REITs, so the total tax paid by foreign and tax-exempt investors on the REIT dividends would be $850 million. That amount is approximately $1.764 billion less than foreign and tax-exempt investors would have paid had they held the same property through partnerships.[429] Consequently, partnership-to-REIT formations cause $1.764 billion of lost tax revenue. That amount is almost seven times greater than the $258 million of tax revenue lost from REIT spinoffs, but the $1.764 billion lost tax revenue is still only 0.0636 percent of total government receipts in 2013.[430] Consequently, even though the loss of tax revenue due to partnership-to-REIT formation is counterintuitive, the tax revenue effect of such formations is nominal.

D. *Summary of the Tax-Revenue Effect of REIT Taxation*

This analysis illustrates that REIT spinoffs have a negligible effect on overall government receipts, even though they may erode the corporate tax base. Counterintuitively, REITs that come into existence instead of forming as partnerships cause more tax-revenue loss than REIT spinoffs. This result is counterintuitive because partnerships are flow-through entities, and REITs are conduits. Nonetheless, the law's subtly-different treatment of income allocated to foreign investors has greater tax-revenue effect than erosion of the corporate tax base. Ironically, the focus of REIT critics should be on partnership-tax-base erosion instead of corporate-tax-base erosion.

Table 9 summarizes the possible tax-revenue effect of REIT taxation of publicly traded REITs, showing that the government appears to lose more tax revenue from REITs forming from partnerships, but that lost revenue is still very modest. In fact, this analysis finds that REIT taxation appeared to

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Managers (Jan. 2014), https://www.law.upenn.edu/live/files/3147-shackelford-impact-of-foreign-withholding.

425. *See supra* text accompanying note 380.

426. *See supra* text accompanying note 384.

427. $3.6 billion ordinary dividend × 15% + 887 million capital gain dividend × 35%.

428. $850 million tax liability ÷ $4.487 billion of allocated taxable income.

429. $2.613 billion – $850 million.

430. Total government receipts in 2013 was $2.775 trillion. *See supra* note 280. $1.022 billion lost tax revenue ÷ $2.775 trillion total 2013 government receipts.

cause slightly more than $2 billion of lost tax revenue in 2013.[431] That amount is just 0.0729 percent of total 2013 government revenue.

Table 9: Summary of Aggregate Tax-Revenue Effect of REIT Taxation of Publicly Traded REITs	
2013 Government Receipts	
Total 2013 government receipts	$2,775,000,000,000
Total 2013 corporate tax revenue	$ 273,506,000,000
Total 2011 corporate taxable income	$ 931,933,000,000 [432]
Total 2012 partnership net income	$ 777,924,000,000 [433]
2013 Dividends by Publicly Traded REITs	
2013 Dividends by all publicly traded REITs	$34,000,000,000
Portion of dividend from equity REITs (91%)	$30,940,000,000
Ordinary Income Portion (69%)	$21,350,000,000
Long-term capital gains portion (17%)	$ 5,260,000,000
Return of capital (14%)	$ 4,331,600,000
Tax-Base Erosion	
Corporate-Tax-Base Erosion	$1,760,000,000
Corporate-Tax-Base Erosion as percentage of 2011 total corporate taxable income	0.19%
Partnership-Tax-Base Erosion	$24,847,000,000
Partnership-Tax-Base Erosion as percentage of 2012 total partnership net income	3.19%

431. $258 million lost from REIT spinoffs + $1.002 billion lost from partnership-to-REIT formations.

432. *See* Statistics of Income, Returns of Active Corporations, Form 1120, Table 16—Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry Tax Year 2011, http://www.irs.gov/uac/SOI-Tax-Stats-Table-16-Returns-of-Active-Corporations,-Form-1120.

433. *See* Statistics of Income, Table 1. *All Partnerships: Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Selected Industrial Group, Tax Year 2012*, http://www.irs.gov/file_source/pub/irs-soi/12pa01.xls.

Table 9: Summary of Aggregate Tax-Revenue Effect of REIT Taxation of Publicly Traded REITs	
Possible Tax Revenue Lost From REIT Spinoffs	
Lost Tax Revenue (assuming REIT spinoffs account for 6.62% of total REIT dividends)	$258,000,000
Lost revenue as a percentage of 2013 total government receipts	0.0093%
Possible Tax Revenue Lost from Foreign and Tax-Exempt Investments in REITs	
Lost Tax Revenue (assuming partnership-to-REIT formations account for 93.38% of total REIT dividends)	$1,764,000,000
Lost Tax Revenue as a percentage of 2013 total government receipts	0.0636%
Possible Aggregate Tax Revenue Lost from REIT Taxation	
Total Lost Tax Revenue	$2,022,000,000
Total Lost Tax Revenue as a percentage of 2013 total government receipts	0.0729%

These findings are fascinating. REITs appear to be increasing in popularity as evidenced by the growing number of REITs and the increasing market value of publicly-traded REITs.[434] REIT spinoffs and other REIT activity has caught the attention of the media, commentators, and lawmakers who focus on how REITs affect the corporate tax base.[435] The analysis in this Article shows that REIT spinoffs can affect tax revenue, but the overall effect of REIT spinoffs on tax revenue is not significant. Surprisingly, the greater tax-revenue effect appears to derive from income that flows through REITs, but otherwise would have flowed through partnerships, but even that larger tax-revenue effect is very modest.[436] Nonetheless, REIT reform has focused on the lesser of two apparently small evils. Commentators should focus more effort on determining the tax-revenue effect of REIT taxation before blindly recommending changes to the law.

434. *See supra* text accompanying notes 21–24.

435. *See supra* text accompanying notes 3–10.

436. This is the same conclusion reached by other analysts who include multiple variables in their estimates of the tax-revenue effect of REIT spinoffs. *See, e.g.*, Goolsbee & Maydew, *Organizational Form*, *supra* note 54, at 444 ("[T]he aggregate tax revenue effect to the Treasury is likely to be modest.").

V. CONCLUSION

This Article presents compelling evidence that the current focus on the effect REIT spinoffs have on the corporate tax base is badly misplaced. The Article proves that a REIT spinoff can erode the corporate tax base but generate tax revenue for the government.[437] The Article also proves that if the tax rates of corporations, corporate shareholders, and REIT shareholders remain constant, tax-exempt ownership does most to determine whether a REIT spinoff will negatively affect tax revenue. Calls for reform must consider this reality. Tax revenue, not the corporate tax base, should be the focus of people who are concerned about declining government receipts. Thus, instead of calling for reform that would merely help preserve the corporate tax base for the sake of the corporate tax base, critics of REIT taxation should focus on the greatest source of lost tax revenue—tax-exempt ownership of REIT stock. The formulas in this Article provide a starting point for considering legislation that would ensure that REITs do not decrease tax revenue. For example, legislation that limits the percentage of REIT stock owned by tax-exempt entities and foreign investors could help ensure that REITs do not cause loss of tax revenue. Existing legislation takes some measures to limit the amount of REIT stock that pension trusts can own, but pension trusts can circumvent those rules fairly easily or make them otherwise innocuous.[438] Other changes could help address the true cause of lost tax revenue.

The other source of lost tax revenue is foreign ownership of REIT stock. Existing legislation and treaties limit the amount of REIT stock that foreign investors may own and still obtain favorable tax treatment.[439] Congress could preserve tax revenue by further narrowing those limits or otherwise control any of the other variables that influence the tax-revenue effect of REIT taxation. Of course, reform could affect more than tax revenue. Lawmakers must consider whether changes to the law would adversely affect the real estate market and national economy. They should also consider the original purpose of the REIT regime, which was to create investment opportunities for small investors and channel capital to real estate markets.[440] If REIT taxation is accomplishing those purposes, perhaps the nominal loss of tax-revenue is a price worth paying to achieve other objectives. A companion article to this one considers policy aspects of various reform alternatives.[441]

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437. *See supra* Part III.B.1.

438. *See* I.R.C. § 856(h)(3)(C).

439. *See supra* text accompanying notes 380–389.

440. *See* H.R. REP. NO. 86-2020, at 3–4 (1960).

441. *See* Borden, *Reforming REIT Taxation*, *supra* note 15. Other proposed reform includes addressing the definition of real estate and reforming the rules governing taxable REIT subsidiaries. *See* Taylor, *supra* note 3 at 244–45; Willard B. Taylor, *Closing the Gap Between Private Letter Rulings and Regulations*, 144 TAX

NOTES 597 (Aug. 4, 2014) (recommending regulatory guidance that would help provide clarity to some aspects of REIT rules).

APPENDIX A: REIT MARKET CAPITALIZATION DATA

End of Year	All REITs		Equity			Mortgage			Hybrid		
	# of REITs	Market Cap	# of REITs	Market Cap	% of Total Cap	# of REITs	Market Cap	% of Total Cap	# of REITs	Market Cap	As % of Total Cap
1971	34	$1,494	12	$332	22%	12	$571	38%	10	$592	40%
1972	46	$1,881	17	$377	20%	18	$775	41%	11	$729	39%
1973	53	$1,394	20	$336	24%	22	$517	37%	11	$540	39%
1974	53	$712	19	$242	34%	22	$239	34%	12	$232	33%
1975	46	$900	12	$276	31%	22	$312	35%	12	$312	35%
1976	62	$1,308	27	$410	31%	22	$416	32%	13	$483	37%
1977	69	$1,528	32	$538	35%	19	$398	26%	18	$592	39%
1978	71	$1,412	33	$576	41%	19	$340	24%	19	$496	35%
1979	71	$1,754	32	$744	42%	19	$377	21%	20	$633	36%
1980	75	$2,299	35	$942	41%	21	$510	22%	19	$847	37%
1981	76	$2,439	36	$978	40%	21	$541	22%	19	$920	38%
1982	66	$3,299	30	$1,071	32%	20	$1,133	34%	16	$1,094	33%
1983	59	$4,257	26	$1,469	34%	19	$1,460	34%	14	$1,329	31%
1984	59	$5,085	25	$1,795	35%	20	$1,801	35%	14	$1,489	29%
1985	82	$7,674	37	$3,270	43%	32	$3,162	41%	13	$1,241	16%
1986	96	$9,924	45	$4,336	44%	35	$3,626	37%	16	$1,962	20%
1987	110	$9,702	53	$4,759	49%	38	$3,161	33%	19	$1,782	18%
1988	117	$11,435	56	$6,142	54%	40	$3,621	32%	21	$1,673	15%
1989	120	$11,662	56	$6,770	58%	43	$3,536	30%	21	$1,356	12%
1990	119	$8,737	58	$5,552	64%	43	$2,549	29%	18	$636	7%
1991	138	$12,968	86	$8,786	68%	28	$2,586	20%	24	$1,596	12%
1992	142	$15,912	89	$11,171	70%	30	$2,773	17%	23	$1,968	12%
1993	189	$32,159	135	$26,082	81%	32	$3,399	11%	22	$2,678	8%
1994	226	$44,306	175	$38,812	88%	29	$2,503	6%	22	$2,991	7%
1995	219	$57,541	178	$49,913	87%	24	$3,395	6%	17	$4,233	7%
1996	199	$88,776	166	$78,302	88%	20	$4,779	5%	13	$5,696	6%
1997	211	$140,534	176	$127,825	91%	26	$7,370	5%	9	$5,338	4%
1998	210	$138,301	173	$126,905	92%	28	$6,481	5%	9	$4,916	4%
1999	203	$124,262	167	$118,233	95%	26	$4,442	4%	10	$1,588	1%
2000	189	$138,715	158	$134,431	97%	22	$1,632	1%	9	$2,652	2%
2001	182	$154,899	151	$147,092	95%	22	$3,991	3%	9	$3,816	2%
2002	176	$161,937	149	$151,272	93%	20	$7,146	4%	7	$3,519	2%
2003	171	$224,212	144	$204,800	91%	20	$14,187	6%	7	$5,225	2%
2004	193	$307,895	153	$275,291	89%	33	$25,964	8%	7	$6,639	2%
2005	197	$330,691	152	$301,491	91%	37	$23,394	7%	8	$5,807	2%
2006	183	$438,071	138	$400,741	91%	38	$29,195	7%	7	$8,134	2%
2007	152	$312,009	118	$288,695	93%	29	$19,054	6%	5	$4,260	1%
2008	136	$191,651	113	$176,238	92%	20	$14,281	7%	3	$1,133	1%
2009	142	$271,199	115	$248,355	92%	23	$22,103	8%	4	$741	0%
2010	153	$389,295	126	$358,908	92%	27	$30,387	8%	--	--	--
2011	160	$450,501	130	$407,529	90%	30	$42,972	10%	--	--	--
2012	172	$603,415	139	$544,415	90%	33	$59,000	10%	--	--	--
2013	202	$670,334	161	$608,277	91%	41	$62,057	9%	--	--	--

* All dollar amounts in millions.
Source: REIT.com, *U.S. REIT Industry Equity Maket Cap--Historical REIT Industry Maket Capitalization: 1972-2013, available at* http://www.reit.com/investing/industry-data-research/us-reit-industry-equity-market-cap.

APPENDIX B: CONVENTIONAL ANALYSIS OF SINGLE REIT SPINOFF

No Spinoff			
Taxable Income From Real Estate			$1,000,000,000
Interest Deduction	$128,000,000		
Depreciation Deduction	$388,200,000		
Rental Deduction	$0		
Total Deduction			$516,200,000
Taxable Income			$483,800,000
Corporate Tax Rate		35%	
Corporate Tax Liability			$169,330,000
Amount Distributed to Shareholders			$314,470,000
Shareholder Tax Rate		23.8%	
Shareholder Tax Liability			$74,843,860
After-Tax to Shareholder			$239,626,140
Total Tax			$244,173,860
Total Tax as Percentage of Taxable Income			50.47%
With Spinoff			
Op Corp			
Taxable Income From Real Estate			$1,000,000,000
Interest Deduction	$0		
Depreciation Deduction	$0		
Rental Deduction	$650,000,000		
Total Deduction			$650,000,000
Taxable Income			$350,000,000
Corporate Tax Rate		35%	
Corporate Tax Liability			$122,500,000
Amount Distributed to Shareholders			$227,500,000
Shareholder Tax Rate		23.8%	
Shareholder Tax Liability			$54,145,000
After-Tax to Shareholder			$173,355,000
REIT			
Taxable Income			$650,000,000
Interest Deduction	$128,000,000		
Depreciation Deduction	$388,200,000		
Total Deduction			$516,200,000
Taxable Income			$133,800,000
Corporate Tax Rate		0%	
Corporate Tax Liability			$0
Amount Distributed			$133,800,000
Shareholder Tax Rate		43.4%	
Shareholder Tax Liability			$58,069,200
After-Tax to Shareholder			$75,730,800
Overall Effect			
Total Shareholder Tax Liability			$112,214,200
Total After-Tax to Shareholder			$249,085,800
Distribution Benefit to Shareholders			$9,459,660
Benefit to Corporation			$46,830,000
Total Tax			$234,714,200
Total Tax as Percentage of Taxable Income			48.51%

APPENDIX C: DYNAMIC ANALYSIS OF SINGLE REIT SPINOFF

No Spinoff			
Taxable Income Attributed to Real Estate Assets			$1,000,000,000
Interest Deduction	$128,000,000		
Depreciation Deduction	$388,200,000		
Rental Deduction	$0		
Total Deduction			$516,200,000
Taxable Income			$483,800,000
Corporate Tax Rate		35%	
Corporate Tax Liability			$169,330,000
Amount Distributed to Shareholders (25% dividend-payout ratio)			$120,950,000
Shareholder Tax Rate (75% of 23.8%)		17.9%	
Shareholder Tax Liability			$21,589,575
After-Tax to Shareholder			$99,360,425
Total Tax			$190,919,575
Total Tax as Percentage of Taxable Income			39.46%
With Spinoff			
Op Corp			
Taxable Income from Real Estate			$1,000,000,000
Interest Deduction	$0		
Depreciation Deduction	$0		
Rental Deduction	$650,000,000		
Total Deduction			$650,000,000
Taxable Income			$350,000,000
Corporate Tax Rate		35%	
Corporate Tax Liability			$122,500,000
Amount Distributed to Shareholders (25% dividend-payout ratio)			$87,500,000
Shareholder Tax Rate (75% of 23.8%)		17.85%	
Shareholder Tax Liability			$15,618,750
After-Tax to Shareholder			$71,881,250
REIT			
Taxable Income			$650,000,000
Interest Deduction	$128,000,000		
Depreciation Deduction	$388,200,000		
Total Deduction			$516,200,000
Taxable Income			$133,800,000
Corporate Tax Rate		0%	
Corporate Tax Liability			$0
Amount Distributed			$133,800,000
Shareholder Tax Rate (75% of 43.4%)		32.55%	
Shareholder Tax Liability			$43,551,900
After-Tax to Shareholder			$90,248,100
Overall Effect			
Total Shareholder Tax Liability			$59,170,650
Total After-Tax to Shareholder			$162,129,350
Distribution Benefit to Shareholders			$62,768,925
Reduction of Corporate Tax Liability			$46,830,000
Total Tax			$181,670,650
Total Tax as Percentage of Taxable Income			37.55%

APPENDIX D: TAX-REVENUE EFFECT OF 2013 REIT DIVIDENDS

Deconstructed 2013 REIT Dividends			
Total REIT Dividends (2013)			$34,000,000,000
Equity REIT Dividends (91% of total)			$30,940,000,000
Dividends Attributable to Equity REITs			
Taxable Income Portion (86%) of Equity REIT Dividend)			$26,608,400,000
Ordinary Income Portion (69%)			$21,348,600,000
Capital Gain Portion (17%)			$5,259,800,000
Return of Capital Portion (14%)			$4,331,600,000
Aggregate Effect of REIT Spinoffs			
Dividends Attributable to REIT Spinoffs			
Portion of Equity-REIT Dividends Attributable to REIT Spinoffs (6.62%)			$2,048,228,000
Ordinary Income Portion (69%) of Spun-Off REIT Dividends			$1,413,277,320
Capital Gain Portion (17%) of Spun-Off REIT Dividends			$348,198,760
Taxable income Portion of Spun-Off REIT Dividends			$1,761,476,080
Treatment if Recognized by a Corporation			
Lost Corporate Taxable Income			$1,761,476,080
Corporate Tax Rate			35%
Corporate Tax Liability			$616,516,628
Distribution (25% dividend-payout ratio)			$440,369,020
Shareholder Tax Rate			16.71%
Shareholder Tax Liability			$73,585,663
Total Potential Tax Liability			$690,102,291
Consequences If Recognized by REIT	Composition of Dividend	Tax Rate	Tax Liability
Ordinary Income Portion	$1,413,277,320	26.59%	$375,790,439
Capital Gain Portion	$348,198,760	16.00%	$55,711,802
Total REIT Shareholder Tax Liability			$431,502,241
Effective Tax Rate on Taxable Income			24.50%
Effect of REIT vs. Corporate Taxation			
Tax Revenue Lost from REIT Spinoffs			$258,600,050
Total 2013 Government Receipts			$2,775,103,000,000
Tax Revenue Lost from REIT Spinoffs as a Percentage of 2013 Receipts			0.0093%
Aggregate Effect of Partnership-to-REIT Formations			
Dividends Attributable to Partnership-to-REIT Formations			
Portion of Equity-REIT Dividends Attributable to Partnership-to-REIT Formations (93.38%)			$24,846,923,920
Portion of Dividend Deemed Allocated to Foreign Investors (21%)			$5,217,854,023
Ordinary Income Portion (69%) of Dividend Deemed Allocated to Foreign Investors			$3,600,319,276
Capital Gain Portion (17%) of Dividend Deemed Allocated to Foreign Investors			$887,035,184
Taxable Income Portion Deemed Allocated to Foreign Investors			$4,487,354,460
Portion of Taxable Income Deemed Allocated to Tax-Exempt Investors (25%)			$6,211,730,980
Debt-Financed Portion of Income Deemed Allocated to Tax-Exempt Investors (34.1%)			$2,118,200,264
Treatment if Recognized by Partnership	Composition of Allocation	Tax Rate	Tax Liability
Ordinary Income Portion	$3,600,319,276	43.40%	$1,562,538,566
Capital Gain Portion	$887,035,184	35.00%	$310,462,314
Total Foreign Partner Tax Liability			$1,873,000,880
Total Tax-Exempt Partner Tax Liability			$741,370,092
Total Tax Liability of Non-Individual Investors			$2,614,370,973
Consequences if Recognized by REIT	Composition of Dividend	Tax Rate	Tax Liability
Ordinary Income Portion	$3,600,319,276	15.00%	$540,047,891
Capital Gain Portion	$887,035,184	35.00%	$310,462,314
Total Foreign Partner Tax Liability			$850,510,206
Total Tax-Exempt Partner Tax Liability			$0
Total Tax Liability of Non-Individual Investors			$850,510,206
Effect of REIT vs. Partnership Taxation			
Tax Revenue Lost from Partnership-to-REIT Formations			$1,763,860,767
Total 2013 Government Receipts			$2,775,103,000,000
Tax Revenue Lost from Partnership-to-REIT Formations as a Percentage of 2013 Receipts			0.0636%
Aggregate Effect of REIT Taxation			
Aggregate Lost from REIT Taxation			$2,022,460,817
Percentage of Loss from REIT Spinoffs			12.79%
Percentage of Loss from Partnership-to-REIT Formations			87.21%
Total 2013 Government Receipts			$2,775,103,000,000
Aggregate Lost Tax Revenue as a Percentage of 2013 Receipts			0.0729%

APPENDIX E: SIMPLIFICATION OF TAX-REVENUE-EFFECT FORMULA

Formula (4)-Tax-Revenue-Neutral Equation:

$$(\boldsymbol{I_C} \times \boldsymbol{T_C}) + \left((\boldsymbol{I_C} \times \boldsymbol{P}) \times \boldsymbol{T_S} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + (\boldsymbol{I_C} \times \boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}) = \left((\boldsymbol{I_C} - \boldsymbol{I_R}) \times \boldsymbol{T_C})\right) + \left(((\boldsymbol{I_C} - \boldsymbol{I_R}) \times \boldsymbol{P}) \times \boldsymbol{T_S} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + \left((\boldsymbol{I_C} - \boldsymbol{I_R}) \times \boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}\right) + \left(\boldsymbol{I_R} \times \boldsymbol{T_R} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + (\boldsymbol{I_R} \times \boldsymbol{T_F} \times \boldsymbol{F})$$

Rewrite:

$$(\boldsymbol{I_C} \times \boldsymbol{T_C}) + \left((\boldsymbol{I_C} \times \boldsymbol{P}) \times \boldsymbol{T_S} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + (\boldsymbol{I_C} \times \boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}) = (\boldsymbol{I_C} \times \boldsymbol{T_C}) - (\boldsymbol{I_R} \times \boldsymbol{T_C}) + \left(((\boldsymbol{I_C} - \boldsymbol{I_R}) \times \boldsymbol{P}) \times \boldsymbol{T_S} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + \left((\boldsymbol{I_C} - \boldsymbol{I_R}) \times \boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}\right) + \left(\boldsymbol{I_R} \times \boldsymbol{T_R} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + (\boldsymbol{I_R} \times \boldsymbol{T_F} \times \boldsymbol{F})$$

Subtract $(I_C \times T_C)$ *from both sides and rewrite*:

$$\left(\boldsymbol{I_C} \times \boldsymbol{P} \times \boldsymbol{T_S} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + (\boldsymbol{I_C} \times \boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}) = -(\boldsymbol{I_R} \times \boldsymbol{T_C}) + \left(\boldsymbol{I_C} \times \boldsymbol{P} \times \boldsymbol{T_S} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) - \left(\boldsymbol{I_R} \times \boldsymbol{P} \times \boldsymbol{T_S} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + (\boldsymbol{I_C} \times \boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}) - (\boldsymbol{I_R} \times \boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}) + \left(\boldsymbol{I_R} \times \boldsymbol{T_R} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + (\boldsymbol{I_R} \times \boldsymbol{T_F} \times \boldsymbol{F})$$

Subtract $\left(I_C \times P \times T_S \times (1 - V + F)\right)$ *and* $(I_C \times P \times F \times T_F)$ *from both sides and rewrite:*

$$\boldsymbol{I_R} \times \boldsymbol{T_C} = -\left(\boldsymbol{I_R} \times \boldsymbol{P} \times \boldsymbol{T_S} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) - (\boldsymbol{I_R} \times \boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}) + \left(\boldsymbol{I_R} \times \boldsymbol{T_R} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + (\boldsymbol{I_R} \times \boldsymbol{T_F} \times \boldsymbol{F})$$

Divide both sides by I_R:

$$\boldsymbol{T_C} = -\left(\boldsymbol{P} \times \boldsymbol{T_S} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) - (\boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}) + \left(\boldsymbol{T_R} \times \left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right)\right) + (\boldsymbol{T_F} \times \boldsymbol{F})$$

Factor out $\left(1 - (V + F)\right)$ *and rewriting to get the tax-revenue-neutral formula:*

$$\boldsymbol{T_C} = (\boldsymbol{T_R} - \boldsymbol{P} \times \boldsymbol{T_S})\left(\mathbf{1} - (\boldsymbol{V} + \boldsymbol{F})\right) - (\boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}) + (\boldsymbol{T_F} \times \boldsymbol{F})$$

Rewrite:

$$\boldsymbol{T_C} = (\boldsymbol{T_R} - \boldsymbol{P} \times \boldsymbol{T_S}) - (\boldsymbol{T_R} - \boldsymbol{P} \times \boldsymbol{T_S}) \times \boldsymbol{V} - (\boldsymbol{T_R} - \boldsymbol{P} \times \boldsymbol{T_S}) \times \boldsymbol{F} - (\boldsymbol{P} \times \boldsymbol{F} \times \boldsymbol{T_F}) + (\boldsymbol{T_F} \times \boldsymbol{F})$$

Rewrite:

$$T_C = T_R - P \times T_S - T_R \times V + P \times T_S \times V - T_R \times F + P \times T_S \times F - (P \times F \times T_F) + T_F \times F$$

Rewrite:

$$T_C = T_R - T_R V - T_R F - T_S P + T_S PV + T_S PF + T_F F - T_F PF$$

Factor and rewrite:

$$T_C = T_R(1 - V - F) - T_S(P - PV - PF) + T_F(F - PF)$$

APPENDIX F: TAX-EXEMPT OWNERSHIP BREAKEVEN POINT

Formula (4)

$$(I_C \times T_C) + \left((I_C \times P) \times T_S \times (1 - (V + F))\right) + (I_C \times P \times F \times T_F) = \left(((I_C - I_R) \times T_C)) + \left(((I_C - I_R) \times P) \times T_S \times (1 - (V + F))\right) + ((I_C - I_R) \times P \times F \times T_F) + \left(I_R \times T_R \times (1 - (V + F))\right) + (I_R \times T_F \times F)\right)$$

Assume: I_C = \$484 million
I_R = \$134 million
T_C = 35%
T_S = 23.8%
T_R = 43.4%
T_F = 15%
P = 25%
F = 0
V = unknown

Solving for the maximum tax-exempt ownership percentage that will not cause the REIT spinoff to have a negative tax effect.

$$(\$484{,}000{,}000 \times 0.35) + \left((\$484{,}000{,}000 \times 0.25) \times 0.238 \times (1 - (V + 0))\right) + (\$484{,}000{,}000 \times 0.25 \times 0 \times 0.15) = ((\$484{,}000{,}000 - \$134{,}000{,}000) \times 0.35)) + \left(((\$484{,}000{,}000 - \$134{,}000{,}000) \times 0.25) \times 0.238 \times (1 - (V + 0))\right) + ((\$484{,}000{,}000 - \$134{,}000{,}000) \times 0.25 \times 0 \times 0.15) + \left(\$134{,}000{,}000 \times 0.434 \times (1 - (V + 0))\right) + (134{,}000{,}000 \times 0.15 \times 0)$$

Multiplying throughout to simplify:

$$\$169{,}400{,}000 + (\$28{,}798{,}000 \times (1 - V)) = \$122{,}500{,}000 + (\$20{,}825{,}000 \times (1 - V)) + (\$58{,}156{,}000 \times (1 - V))$$

Isolating the unknown variable through addition and subtraction:

$$\$46{,}900{,}000 = \$50{,}183{,}000 \times (1 - V)$$

Solving for 1 – V using division and solving for V:

$$0.9346 = 1 - V$$
$$V = 0.0654$$

Therefore, if tax-exempt ownership exceeds 6.54% of Op Corp and the REIT stock, the REIT spinoff will have a negative effect on tax revenue.