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Reforming REIT Taxation (or Not)

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ARTICLE

REFORMING REIT TAXATION (OR NOT)

*Bradley T. Borden**

ABSTRACT

Tax law treats the income of real estate investment trusts (REITs) differently from the income of regular corporations. Income distributed by regular corporations is subject to an entity-level tax and a shareholder-level tax, while taxable income distributed by REITs is subject to tax only at the shareholder level. To qualify for that single level of tax, REITs must hold primarily real estate assets, and their income must be primarily from such assets. After being a relatively insignificant part of the economy for the first three decades of their existence, REITs have become relevant over the last twenty years, with the market capitalization of publicly traded REITs eclipsing 5% of U.S. GDP at the end of 2014. Reports about REITs appear frequently in major media outlets, and many emphasize corporate-tax-base erosion that results from REIT spinoffs and conversions. Calls for REIT reform have been answered with proposed legislation that would change various aspects of REIT taxation. Recent work in this area shows that even though REIT spinoffs and conversions do erode the corporate tax base, the requirement that they distribute income and the higher tax rates of REIT shareholders offset corporate-tax-base erosion and minimize the tax-revenue effects of REIT taxation. This Article examines the history of REIT taxation and identifies Congress's purposes for enacting REIT legislation and amending it over the years. The Article examines some

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criticisms of REIT taxation and analyzes REIT taxation based upon how well it accomplishes Congress's purposes and satisfies traditional tax-policy objectives. Based on that analysis, the Article finds that REIT taxation is benign, and it benefits the economy by helping to stabilize real estate markets. The Article then compares the REIT regime with various reform alternatives. Not surprisingly, after finding that REIT taxation is benign and beneficent, the Article concludes that maintaining the status quo is more attractive than any of the reform alternatives.

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I. INTRODUCTION

Before announcing his retirement from Congress,¹ Representative David Camp, the then-chair of the tax-writing House Ways and Means Committee, proposed reforming aspects of real estate investment trust (REIT) taxation.² Over the past several years, REITs have also made headlines (many of which are critical of REITs) in major news outlets, and the frequency of REIT stories appears to be increasing.³ The Camp Proposal and media

1. Ed O'Keefe & Paul Kane, *House Ways and Means Chair Dave Camp to Retire*, WASH. POST, Apr. 1, 2014, at A3.

2. See Tax Reform Act of 2014, H.R. 1, 113th Cong. (proposing several modifications to REIT taxation, including § 3631 (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), §§ 3633–3634 (proposing modifications of the definition of REIT real property), § 3644 (proposing a modification of the rules governing taxable REIT subsidiary), and § 3647 (proposing denying tax-free corporate conversions to REITs)).

3. See, e.g., Alison Gregor, *Specialty REITs, Exploiting Niche Categories, Outperform the Mainstream Players*, N.Y. TIMES, Dec. 21, 2011, at B6; Thomas Gryta & Ryan Knutson, *IRS Blesses Telecom's Turn to REIT, 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, at B1 (exploring the explosion of REITs, which has “stretched the definition of real estate into new territory, giving American companies another means of minimizing their taxes at a time when corporate tax avoidance has sparked fierce debate in Washington”); Gretchen Morgenson, *A Corporate Tax Break That's Closer to Home*, N.Y. TIMES, Aug. 10, 2014, at BU1; Cecile Daurat & Caitlin McCabe, *Windstream to Spin Off Networks into Publicly Traded REIT*, BLOOMBERG (July 29, 2014), <http://www.bloomberg.com/news/2014-07-29/windstream-to-spin-off-telecom-assets-into-publicly-traded-reit.html>; 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-will-further-erode-the-corporate-tax-base/> (identifying REITs as “an unmistakable opportunity” to minimize taxes); David M. Levitt, *Empire State Realty*

coverage of REIT taxation express concern that REITs erode the corporate tax base and therefore are bad.⁴ Unfortunately, these reports lack critical insight into the history and policy of REIT taxation and the effect it has on tax revenue and the broader economy. This Article provides a critical analysis of REIT taxation and reaches conclusions that are at odds with the popular press's take on REIT taxation.

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).⁵ The comparative market size of each type of REIT has fluctuated over time, but equity REITs have gained prominence over the last three decades.⁶ Despite those fluctuations and market cycles, the growth of REITs has been significant, especially over the last twenty years (see Figure 1).⁷ Important developments in REIT law appear to affect the growth of REITs in varying degrees, so the law deserves careful scrutiny. Some important legal developments include legislation and IRS rulings that liberalized the type of services REITs can perform directly and indirectly through taxable REIT subsidiaries;⁸ opened REIT investment to

Trust Gains After \$929.5 Million IPO, BLOOMBERG (Oct. 2, 2013), <http://www.bloomberg.com/news/2013-10-02/empire-state-realty-trust-gains-after-929-5-million-ipo>; Aaron Levitt, *Why Weird REITs Are Wonderful for Investors*, Investor Place (Feb. 8, 2013), <http://investorplace.com/2013/02/why-weird-reits-are-wonderful-for-investors/#.VCNBmk1OxbU> (identifying cold storage warehouses, cell phone towers, and salt caverns as types of property owned by some specialty REITs); Brian Louis, *Paramount Said to Plan Biggest REIT IPO at \$2.5 Billion*, BLOOMBERG (Aug. 27, 2014), <http://www.bloomberg.com/news/2014-08-27/paramount-group-files-for-ipo-of-u-s-office-landlord.html>; 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/>.

4. See H.R. 1; sources cited *supra* note 3.

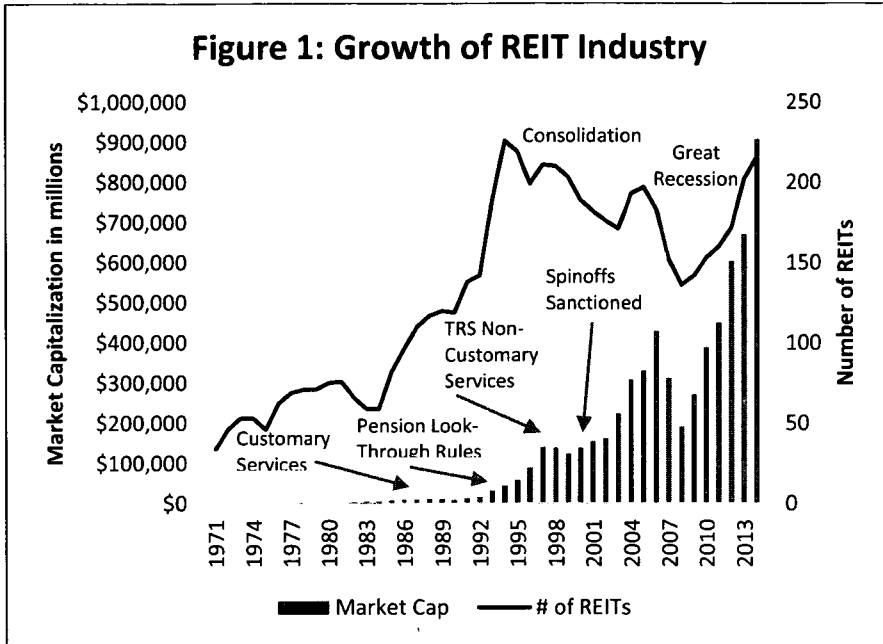
5. See PETER M. FASS, MICHAEL E. SHAFF & DONALD B. ZIEF, *Real Estate Investment Trust Terminology—Types of REITs*, in REAL ESTATE INVESTMENT TRUSTS HANDBOOK § 1:3 (2014); Joel Simpson Marcus, *An Analysis of Qualified Income Interest Problems of Mortgage REITs*, 37 J. TAX'N 348, 348–49 (1972); Manishi Pathak, *India and Real Estate Investment Trusts—A New Movement*, 1 REAL EST. L. 45, 45 (2008); Larry Witner, *Tax Ideas: REITs: The Revolution in Real Estate Financing*, 22 REAL EST. L.J. 248, 249 (1994).

6. See *infra* Appendix A. Information about the size of the REIT market is based on publicly-traded REITs, but REITs can also be held privately. Information about privately-held REITs is not publicly available, but the size of the REIT market is undoubtedly larger than depicted in Figure 1 because of privately-held REITs.

7. The data used to construct the chart in Figure 1 is presented in Appendix A.

8. See *infra* Part II.C.2; see also David M. Einhorn, *Unintended Advantage: Equity REITs vs. Taxable Real Estate Companies*, 51 TAX LAW. 203, 209–18 (1998) (attributing the success of REITs to their success evolving beyond passive investment vehicles).

institutional investors, namely mutual funds, tax-exempt pension funds, and endowments;⁹ and continually updated the definition of real estate assets to include more and more nontraditional real estate.¹⁰



The greatest change in market capitalization as measured by year-over-year growth occurred in 1993.¹¹ That was the year Congress enacted legislation that made REIT stock ownership easier for pension funds,¹² and brought more institutional investment to the REIT market.¹³ The decrease in the number of

9. See *infra* Parts II.C.4, IV.B.1–2.

10. See *infra* Part II.C.8.

11. See *infra* Appendix A.

12. See *infra* Part II.C.4.

13. SU HAN CHAN, JOHN ERICKSON & KO WANG, REAL ESTATE INVESTMENT TRUSTS: STRUCTURE, PERFORMANCE, AND INVESTMENT OPPORTUNITIES 106–08 (2003) (concluding that equity REITs provide more information, which attracts more institutional investors, which causes market capitalization to grow); Su Han Chan, Wai Kin Leung & Ko Wang, *Institutional Investment in REITs: Evidence and Implications*, 16 J. REAL EST. RES. 357, 363–72 (1998) (showing that institutional investment in REIT stock increased significantly after 1993); John L. Crain, Mike Cudd & Christopher L. Brown, *The Impact of the Revenue Reconciliation Act of 1993 on the Pricing Structure of Equity REITs*, 19 J. REAL EST. RES. 275, 277–78 (2000) (analyzing the effect of the enactment of the pension look-through rules).

REITs following 1993 resulted from consolidations.¹⁴ The surge in the number of REITs and market capitalization in 2003 would appear to reflect the reaction to a favorable ruling from the IRS sanctioning tax-free REIT spinoffs,¹⁵ but the number of REIT spinoffs has been limited.¹⁶ The dip from 2007 through 2011 mirrors the Great Recession and events leading up to the 2008 financial crisis.¹⁷ The fluctuations in the number of REITs and REIT market capitalization indicate that changes in the tax law appear to affect investments in REITs, but other forces also play a role in investor decision-making.

The growth rate of REITs is impressive when compared to general economic performance (see Figure 2).¹⁸ For instance, the U.S. gross domestic product grew from under \$1.2 trillion at the end of 1971 to more than \$17.5 trillion at the end of 2014.¹⁹ That 1392% increase is dwarfed by the 60,625% increase of REIT market capitalization (almost \$1.5 billion in 1971 to more than \$907 billion in 2014) over the same period.²⁰

14. See Zhilan Feng, S. McKay Price & C.F. Sirmans, *An Overview of Equity Real Estate Investment Trusts (REITs): 1993–2009*, 19 J. REAL EST. LITERATURE 307, 310 (2011).

15. See *infra* Part II.C.7 (discussing REIT spinoffs).

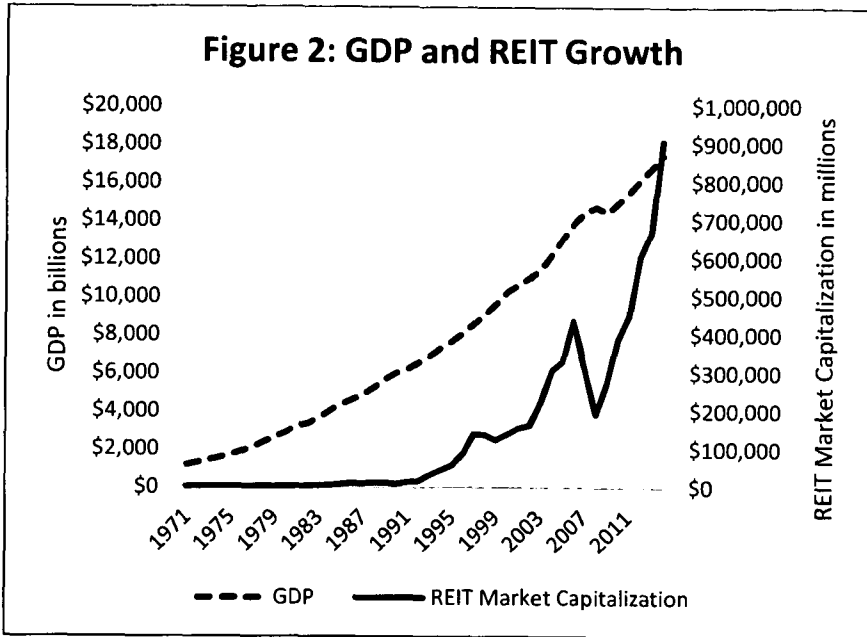
16. See Martin A. Sullivan, *The Revenue Cost of Nontraditional REITs*, 144 TAX NOTES 1103, 1103–04, 1107–11 (2014) (identifying the handful of REIT spinoffs and conversions that have occurred since 2001).

17. See *infra* Appendix A.

18. The data used to construct Figure 2 is reproduced in Appendix A.

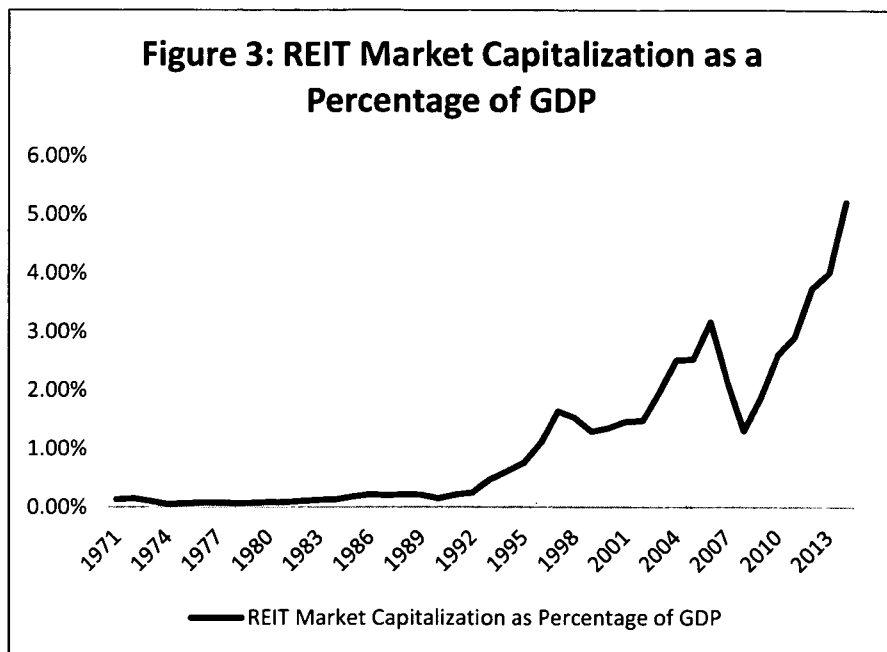
19. See *National Income and Product Accounts Tables, Table 1.1.5: Gross Domestic Product*, U.S. DEPT OF COMMERCE: BUREAU OF ECON. ANALYSIS, <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&903=5> (last updated July 30, 2015).

20. See *infra* Appendix A.



This growth demonstrates that over the last forty years, REITs have become an important part of the economy. In 1971, REIT market capitalization equaled just 0.13% of U.S. GDP, but that number has grown to more than 5% in 2014 (see Figure 3).²¹ Thus, the absolute size of REIT market capitalization is growing, and REITs are becoming an ever-increasing portion of the U.S. economy. The attention that REIT taxation is attracting is warranted.

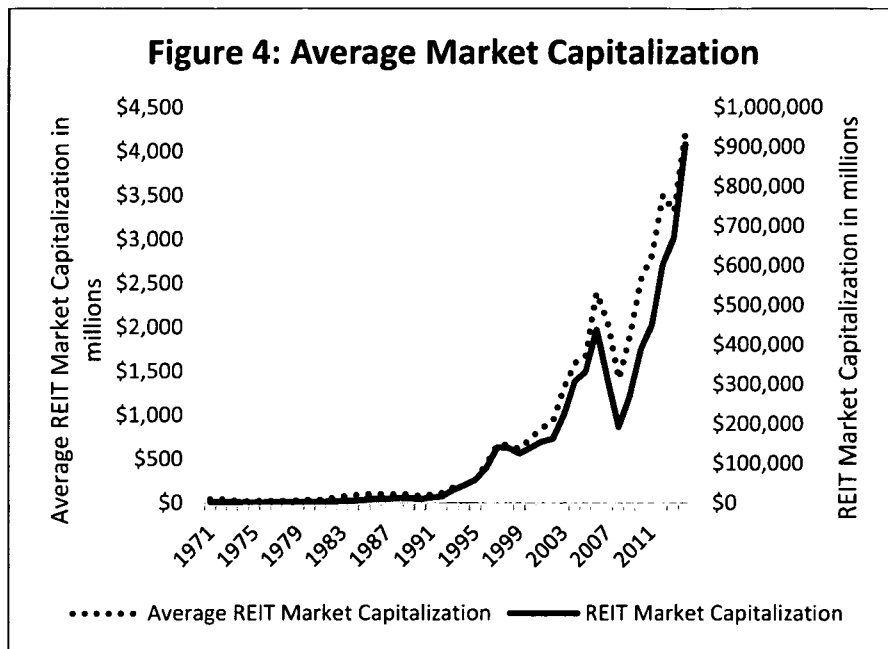
21. The data used to construct Figure 3 is reproduced in Appendix A.



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.²² The change in average market capitalization of publicly traded REITs tracks very closely to the change in overall market capitalization of REITs (see Figure 4).²³ Consequently, the growth appears to be primarily attributable to the size of REITs increasing.

22. See *supra* Figure 1.

23. The data used to construct Figure 4 is reproduced in Appendix A.



REITs have drawn significant attention from the media, the tax bar, nonlegal academics, and lawmakers. For instance, other academic disciplines recognize that “[r]egulatory changes and the sheer growth of the industry render REITs an interesting forum for academic inquiry.”²⁴ In fact, hundreds of articles about REITs are published in accounting, finance, and economics journals, including articles in the leading journals of each of those disciplines, with evidence that the interest in those disciplines is increasing.²⁵ Academic articles in those other disciplines cover a very wide range of topics.²⁶ By contrast the

24. See Feng, Price & Sirmans, *supra* note 14, at 308.

25. See, e.g., J.B. Corgel, W. McIntosh & S.H. Ott, *Real Estate Trusts: A Review of the Financial Economics Literature*, 3 J. REAL EST. LITERATURE 13 (1995) (citing 115 published and unpublished REIT papers written between 1980 and the publication of their 1995 paper); Feng, Price & Sirmans, *supra* note 14 (reporting that 400 published and unpublished REIT papers were written during the fifteen years prior to mid-2009, including 175 written between 2005 and mid-2009).

26. See, e.g., 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) (examining REIT mergers and acquisitions); Bok Baik, Bruce K. Billings & Richard M. Morton, *Reliability and Transparency of Non-GAAP Disclosures by Real Estate Investment Trusts (REITs)*, 83 ACCT. REV. 271 (2008) (analyzing REIT disclosure); David T. Brown, *Liquidity and Liquidation: Evidence from Real Estate Investment Trusts*, 55 J. FIN. 469 (2000) (studying REIT liquidity); William M. Gentry, Deen Kemsley & Christopher J. Mayer, *Dividend Taxes and Share Prices: Evidence from Real Estate Investment Trusts*, 58 J. FIN. 261 (2003) (examining REIT dividends); Jay C. Hartzell, Jarl G. Kallberg & Crocker H. Liu, *The Role*

legal academy has contributed very little to the discussion of REIT taxation.²⁷ Most legal commentary in this area comes from

of *Corporate Governance in Initial Public Offerings: Evidence from Real Estate Investment Trusts*, 51 J.L. & ECON. 539 (2008) (examining corporate governance and REIT IPOs); John S. Howe & James D. Shilling, *Capital Structure Theory and REIT Security Offerings*, 43 J. FIN. 983 (1988) (studying the capital structure and security offerings of REITs); Jeffrey F. Jaffe, *Taxes and the Capital Structure of Partnerships, REITs, and Related Entities*, 46 J. FIN. 401 (1991) (analyzing tax and capital structure of REITs and other entities); Jarl G. Kallberg, Crocker L. Liu & Charles Trzcinka, *The Value Added from Investment Managers: An Examination of Funds of REITs*, 35 J. FIN. & QUANTITATIVE ANALYSIS 387 (2000) (analyzing investment-manager effect); David C. Ling & Michael Ryngaert, *Valuation Uncertainty, Institutional Involvement, and the Underpricing of IPOs: The Case of REITs*, 43 J. FIN. ECON. 433 (1997) (examining institutional involvement in REIT IPOs); Frank Packer, Timothy Riddiough & Jimmy Shek, *Securitization and the Supply Cycle: Evidence from the REIT Market*, 39 J. PORTFOLIO MTG. 134 (2013) (examining the effect publicly traded REITs have on the stability of commercial real estate markets).

27. 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 full-time academics. See, e.g., Sarah G. Austrian & Willys H. Schneider, *Tax Aspects of Foreign Investment in U.S. Real Estate*, 45 TAX LAW. 385 (1992) (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); Bradley T. Borden,* *Rethinking the Tax-Revenue Effect of REIT Taxation*, 17 FLA. TAX REV. 527 (2015) [hereinafter Borden, *Rethinking the Effect*] (using a dynamic analysis to show that the tax-revenue effect of REIT taxation is nominal with counterintuitive results relating to REIT spinoffs and partnership-to-REIT formations); John P. Carroll, Jr., *Tax Policy for the Real Estate Investment Trusts*, 28 TAX L. REV. 299 (1973) (discussing policy aspects of several of the REIT requirements); Emily Cauble,* *Taxing Publicly Traded Entities*, 6 COLUM. J. TAX L. 147 (arguing that only income from publicly-traded property should qualify for conduit and pass-through treatment for publicly traded entities like REITs and publicly traded partnerships); 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); David M. Einhorn, Adam O. Emmerich & Robin Panovka, *REIT M&A Transactions—Peculiarities and Complications*, 55 BUS. LAW. 693 (2000) (discussing mergers and acquisitions of REITs); Einhorn, *supra* note 8 (discussing the then-current practices of REITs); Dudley J. Godfrey, Jr. & Joseph H. Bernstein, *The Real Estate Investment Trust—Past, Present and Future*, 1962 WIS. L. REV. 637 (providing a contemporary account of the original REIT legislation); 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); 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); Simon Johnson, *Reinvigorating the REIT's Neutrality and Capital Formation Purposes Through a Modernized Tax Integration Model*, 7 J. BUS. ENTREPRENEURSHIP & L. 63 (2013) [hereinafter Johnson, *Reinvigorating the REIT's Neutrality*] (arguing that Congress should reform REIT taxation to improve the capitalization rules that currently require REITs to distribute almost all of their taxable income); 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); William A. 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); Theodore Lynn, *Real Estate Investment Trusts: Problems and Prospects*, 31 FORDHAM L. REV. 73 (1962)

the tax bar.²⁸ The oversight by the legal academy of such a

(discussing the then-newly-enacted REIT tax 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); William L. Martin, II, *Federal Regulation of Real Estate Investment Trusts: A Legislative Proposal*, 127 U. PA. L. REV. 316 (1978) (proposing legislation for REITs that would put REITs and RICs on similar ground); 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); 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); 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 the Asian REIT market); Robert J. Staffaroni, *Foreign Investors in RICs and REITs*, 56 TAX LAW. 511 (2003) (discussing the tax aspects of RICs and REITs and the tax consequences of foreign investment in such arrangements); Alessandra Suuberg, *REIT Conversions in Context: A Case Study for the Tax Planning Initiative*, 44 REAL EST. L.J. (forthcoming 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2545368 (discussing REIT conversions and spinoffs); 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); Mitchell N. Baron, Comment, *Tax Status of Real Estate Investment Trusts: A Reassessment*, 9 COLUM. J.L. & SOC. PROBS. 166 (1973) (arguing that the REIT requirements should be relaxed to help additional capital flow to low-income housing); 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); 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); Note, *Managing the Real-Estate Investment Trust: An Alternative to the Independent Contractor Requirement*, 107 HARV. L. REV. 1117 (1994) [hereinafter Harvard Note] (discussing the rules governing the types of services that REITs can provide directly or through contractors); Russell J. Singer, Note, *Understanding REITs, UPREITs, and DownREITs, and the Tax and Business Decisions Surrounding Them*, 16 VA. TAX REV. 329 (1996) (focusing on particular REIT structures); 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 then-loophole in state tax rules that allow operating companies to generate deductions by circulating money through a REIT and holding company); 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); 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). * The asterisk identifies the only authors who appear to have been members of a law school faculty at the time of article publication.

28. A small sampling of REIT articles appearing in professional tax journals illustrates the topics that the tax bar covers. See, e.g., Peter E. Boos, *Runaway REIT Train? Impact of Recent IRS Rulings*, 144 TAX NOTES 1289 (2014) (arguing that recent trends in REIT rulings diverge from Congress's original intent, and recommending a narrower definition of real property, restrictions on the types of services REITs can perform, and curtailment of REIT conversions); Roger Brown, John Staples & Jeremy Huish, *Internal Controls for Withholding Agents on Income From REITs*, 111 TAX NOTES 1115 (2006) (discussing foreign investments in U.S. REITs); Paul W. Decker, David H. Kaplan & Ameet Ashok Ponda, *Original Intent: Revenues for Noncustomary Services Furnished by REIT*

significant area of the law is surprising. Perhaps that oversight is partly responsible for reports that do not fully appreciate the ramifications of REIT taxation. This Article is therefore somewhat of a rarity, and it presents information and analysis that should become important to commentators who cover REIT taxation and provides a framework for future analyses of REIT taxation.

The Article proceeds as follows. Part II provides a comprehensive review of REIT taxation by recounting the history of REITs and the evolution of REIT law over the last five decades and by identifying the law's stated legislative purposes. The review reveals that changes to the law over the years have made the growth of the REIT industry possible, but the REIT regime remains true to its original purposes of providing real-estate investment opportunities to a broad cross section of the population and channeling capital to the real estate markets. Part III considers whether there is a problem with REITs from a tax-policy perspective. The analysis in that Part shows that even though REIT taxation is susceptible to policy critiques, its shortcomings are not obvious when the criticisms are subject to careful consideration. In fact, the analysis suggests that the greatest

TRSS, 148 TAX NOTES 413 (2015) (discussing the rules governing services that a REIT can provide); Paul W. Decker, Ameek Ashok Ponda & Jonathan Stein, *Toward a Workable Definition of REIT Healthcare Facility*, 133 TAX NOTES 1231 (2011) (contending that the IRS erred in privately ruling that an independent living facility does not come within the REIT definition of healthcare facility and suggesting legislation or an IRS ruling that allows taxpayers to elect to treat independent living facilities as a healthcare facility); Ezra Dyckman & Daniel W. Stahl, *Opportunities and Pitfalls in Structuring UPREIT Transactions*, 142 TAX NOTES 95 (2014) (explaining UPREITs); Richard M. Lipton & Patricia W. McDonald, *Foreign Investment in U.S. Real Estate: The FATCA/FIRPTA Dichotomy*, 120 J. TAX'N 248 (2014) (discussing how the law treats foreign investments in U.S. real estate through REIT and other investment vehicles); Richard M. Nugent, *REIT Spinoffs: Passive REITs, Active Businesses*, 146 TAX NOTES 1513 (2015) [hereinafter Nugent, *REIT Spinoffs*] (arguing that the law supports tax-free REIT spinoffs, REIT spinoffs are not a drain on tax revenues, and that the REIT definition of real property reflects a current application of long-existing standard); Richard M. Nugent, *REIT Spinoffs: Passive REITs, Active Businesses, Part 2*, 146 TAX NOTES 1635 (2015); Ameek Ashok Ponda, *Foreign Pension Plans Investments in U.S. REITs*, 74 TAX NOTES 1593 (1997) (discussing the rules governing foreign pension plans investing in U.S. REITs and the tax rates on REIT dividends as provided for in various treaties); Ameek Ashok Ponda, *How Much Gain Would a REIT Defer if a REIT Could Defer Gain?*, 135 TAX NOTES 1249 (2012) (discussing the built-in gains tax and purging dividends to which REITs are subject after a conversion or spinoff); Willard B. Taylor, *Closing the Gap Between Private Rulings and Regulations*, 144 TAX NOTES 597 (2014) [hereinafter Taylor, *Closing the Gap*] (summarizing regulations proposed in 2014 that would codify the definition of real property that has emerged in several private letter rulings); Willard B. Taylor, *More Comments on Camp's REIT Proposals*, 143 TAX NOTES 243 (2014) [hereinafter Taylor, *Comments on Camp Proposal*] (commenting on the Camp Proposal and recommending other REIT reform alternatives).

failing of the REIT regime is that it simply might look bad to the lay observer. Nonetheless, studies show that REITs benefit the economy, and those benefits appear to offset any negative consequences of REIT taxation.²⁹ Because REIT taxation withstands thoughtful tax-policy analysis, Part IV concludes that the reform proposals generally do not promise to improve the situation and that maintaining the status quo appears to be the best course of action at the present time. Part V concludes.

II. OVERVIEW OF REIT TAXATION

Recounting the history of REIT taxation provides an opportunity to consider whether changes to the REIT law have influenced investment and whether capital demand hypothesis helps explain part of the increasing popularity of REITs.³⁰ If the taxpayer-friendly changes to the law have increased REIT popularity, certainly future taxpayer-friendly changes will further increase the popularity of REITs. Alternatively, changes that narrow the scope of REIT taxation could adversely affect the popularity of REITs and could stem the flow of capital to U.S. real estate markets. Of course, REIT popularity may not be the appropriate purpose for modifying REIT taxation. Indeed, some proponents of change argue that the preservation of the corporate tax base should motivate the changes.³¹ The following discussion reveals the stated purpose of REIT taxation and provides a framework for analyzing various reform alternatives.

A. *Prologue to REIT Taxation (1800s–1960)*

REIT taxation became a part of the U.S. tax system in 1960,³² but the history of REITs appears to trace back to the nineteenth century when several real estate trusts formed in

29. See CHAN, ERICKSON & WANG, *supra* note 13, at 40–42 (examining different studies which show that the advantages of REIT taxation outweigh the disadvantages).

30. The capital demand hypothesis provides that a change in the economic environment, including changes to the law, can increase investment opportunities and change the demand for capital. See Feng, Price & Sirmans, *supra* note 14, at 310 (linking demand for REIT stock to regulatory changes); Richard J. Buttimer, David C. Hyland & Anthony B. Sanders, *REITs, IPO Waves and Long-Run Performance*, 33 REAL EST. ECON. 51, 53–54, 68–79, 83–85 (2005) (presenting support for the capital demand hypothesis and the relationship between IPOs and regulatory changes).

31. See Boos, *supra* note 28, at 1298–99 (suggesting that the erosion of the corporate tax base should motivate changes).

32. See Excise Tax Upon Cigars, Pub. L. No. 86-779 §§ 856–858, 74 Stat. 998, 1003–08 (1960); Siemann, *supra* note 27, at 280 (providing a recent recounting of the legislative history of REIT taxation).

Massachusetts.³³ When Congress enacted the 1909 corporate income tax act, the tax status of REITs became important because if they were classified as corporations, their income would be subject to the corporate income tax.³⁴ In 1910, the Supreme Court held that real estate trusts formed for the purpose of purchasing, improving, holding, and selling lands and buildings were not subject to the corporate income tax.³⁵ The tax classification of real estate trusts came into question again, however, after Congress enacted the income tax in 1913.³⁶ The Supreme Court held that a real estate trust came within the definition of corporation under the new statute, so they became subject to income tax.³⁷ The ruling was broad enough to reach mutual funds and also subject them to an entity-level tax. The mutual fund reacted quickly to the imposition of the income tax and convinced Congress to enact legislation in 1936 that would allow security portfolios, such as mutual funds, to deduct dividends they distributed to their members.³⁸ The real-estate-trust industry languished following the Supreme Court's ruling, but eventually Congress enacted legislation that breathed some life into the industry.³⁹

One prominently stated purpose of REIT taxation was to create parity between investments in real estate portfolios and investments in securities portfolios.⁴⁰ Beginning in 1936, regulated investment companies (RICs), which include mutual funds,⁴¹ that satisfied several requirements did not have to pay an

33. See Henry Rottschaefer, *Massachusetts Trust Under Federal Tax Law*, 25 COLUM. L. REV. 305, 307 (1925) (attributing the first extensive development of business trusts to Massachusetts); Suuberg, *supra* note 27 (recounting the history of REITs); Sabrina R. Pellerin, Steven J. Sabol & John R. Walter, *mREITs and Their Risks 2* (Fed. Reserve Bank of Richmond, Working Paper No. 13-19R, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2357070# (claiming that "REITs have been important players in the real estate market since the late 1800s or earlier").

34. See Tariff of 1909, ch. 6, § 38, 36 Stat. 11, 112 (1909) (imposing a 1% tax on the income of every corporation, joint stock company, or association organized for profit and having a capital stock represented by shares).

35. *Eliot v. Freeman*, 220 U.S. 178, 187 (1910).

36. See Tariff of 1913, ch. 16, §§ II.A subdiv. 2, II.G(a), 38 Stat. 114, 166, 172 (1913) (imposing a tax on corporations, joint-stock companies, and associations).

37. *Morrissey v. Comm'r*, 296 U.S. 344, 360–62 (1935).

38. See Suuberg, *supra* note 27, at 15–16.

39. See Godfrey & Bernstein, *supra* note 27, at 642.

40. 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.").

41. See Samuel D. Brunson, *The Taxation of RICs: Replicating Portfolio Investment or Eliminating Double Taxation?*, 20 STAN. J.L. BUS. & FIN. (forthcoming 2015) (manuscript at 2–3), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2486762.

entity-level tax on distributed earnings.⁴² Although aspects of some of the requirements have changed since 1936, tax law still allows RICs to deduct qualifying dividend payments made to shareholders and thereby avoid entity-level taxes, if they satisfy an organizational test, an income test, and an asset test.⁴³ To satisfy the organizational test today, the RIC must be a domestic corporation registered under the Investment Company Act of 1940 (or elect under such Act to be a business development company) or be a common trust fund or similar fund excepted by such Act and not otherwise taxed as a “common trust fund.”⁴⁴ To satisfy the asset and income tests, at least 50% of the arrangement’s assets must be cash and diversified securities,⁴⁵ 90% of the arrangement’s income must come from passive-type investments in securities,⁴⁶ and the arrangement must distribute at least 90% of its taxable income to shareholders.⁴⁷ The asset test specifically includes a diversification requirement under which not more than 5% of the total value of a RIC’s assets represented by securities of a single issuer count toward the 50% asset requirement.⁴⁸ Furthermore, not more than 25% of the total value of its assets can be represented by securities of a single issuer or of two or more issuers that the RIC controls, or qualified publicly traded partnerships.⁴⁹ These requirements are intended to help limit the

42. See Revenue Act of 1936, Pub. L. No. 74-740, §§ 13(a)(3), 48(e), 49 Stat. 1648, 1655, 1669 (1936) (providing a credit to mutual investment companies for amount of dividend paid, and defining mutual investment companies—the term used for RICs in the original act—as any corporation that distributes at least 90% of its income to shareholders as taxable dividends and that derives at least 95% of its gross income from dividends, interest, and gains from dispositions of property); John Morley, *Collective Branding and the Origins of Investment Fund Regulation*, 6 VA. L. & BUS. REV. 341, 358–61 (2012) (describing the original 1936 law).

43. See I.R.C. § 852(b) (2012); Stephen D. Fisher, *RICs and the Retail Investor: A Marriage of Convenience or Necessity?*, 66 TAX LAW. 331, 339–40 (2013) (discussing RICs and other types of passthrough and conduit entities).

44. §§ 851(a), 584(a) (defining common trust fund).

45. § 851(b)(3)(A).

46. § 851(b)(2).

47. § 852(a).

48. See § 851(b)(3)(A)(ii) (providing further that the RIC’s ownership of more than 10% of voting securities of such issuer does not count toward the 50% asset requirement).

49. § 851(b)(3)(B). When discussing the tax treatment of an entity or its members, this Article uses the term “partnership” to refer to any arrangement that comes within the federal tax definition of partnership, which may include state-law partnerships and limited liability companies. See Treas. Reg. § 301.7701-1 to -3 (as amended in 2011, 2012, and 2006, respectively) (establishing the difference between a partnership and corporation for federal tax purposes); Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 971, 975 (2006) (discussing various tests used to define partnership for federal tax purposes).

erosion of the corporate tax base by making RIC taxation available only to arrangements that have limited business activities.⁵⁰ The effect of the dividend deduction granted to RICs is that income they earn is generally taxed only once, even though RICs come within the definition of an association taxable as a corporation (i.e., a tax corporation).⁵¹ Thus, arrangements that satisfy the RIC requirements are generally not subject to an entity-level tax, but the shareholders pay tax on dividends they receive from the RIC at the appropriate rates.⁵²

The stated purpose for granting favorable tax treatment to RICs was to extend opportunities to invest in diversified portfolios of assets to a larger percentage of the population.⁵³ Without RIC taxation, investors had to purchase directly the securities of numerous corporations to obtain diversified portfolios and avoid a second level of taxation. Previously, the opportunity to diversify in such a manner was generally only available to relatively wealthy individuals who could get the benefits of professional management by hiring their own trustee to manage their private portfolios.⁵⁴ Individuals who lacked the resources to create directly such portfolios could invest in portfolio companies created as investment trusts, which were entities formed to acquire and manage diversified portfolios of securities.⁵⁵ The problem with such arrangements prior to 1936 was that they came within the definition of tax corporation and were subject to entity-level taxation, so the tax consequences of investing through investment trusts were prohibitive.⁵⁶ Because portfolio companies often

50. See Brunson, *supra* note 41 (manuscript at 17) ("In enacting the RIC qualification requirements, Congress has created a fence around the world of quasi-pass-through entities, one which limits the erosion of the corporate tax base.").

51. See *id.* (manuscript at 22); Fisher, *supra* note 43, at 339–40.

52. See § 854(b)(1)(B)(i). If at least 95% of the RIC's income is qualified dividend income, distributions to RIC shareholders will be qualified dividend income that qualifies for the favorable tax rates. See § 1(h)(1)(D), (h)(11). If less than 95% of the RIC's income is qualified dividend income, then the only portion of a RIC distribution that is qualified dividend income to the RIC shareholders is that portion which equals the portion of the RIC's total income that is qualified dividend income. See § 854(b)(1)(B)(i) (flush language).

53. See Brunson, *supra* note 41, (manuscript at 23) ("RICs were designed as a way for unsophisticated, low-to-middle-income investors to get the benefits of diversification and professional portfolio management.").

54. See Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1483 (1991).

55. See *Revenue Act of 1936: Hearings on H.R. 12395 Before the S. Comm. on Fin.*, 74th Cong., pt. 10, at 60 (1936) (statement of Arthur H. Kent, Acting Chief Counsel to the Bureau of Internal Revenue); Roe, *supra* note 54, at 1475.

56. See *Morrissey v. Comm'r*, 296 U.S. 344, 360–62 (1935) (holding that an investment trust was an association subject to corporate taxation); Roe, *supra* note 54, at

primarily hold stock in corporations, the tax at the portfolio-company level became a third level of tax.⁵⁷ First, the income of each investee corporation was subject to tax. Second, dividends received by the portfolio from investee corporations were subject to the portfolio company's corporate tax. Third, dividends paid by the portfolio company to its shareholders were subject to tax. The tax at the portfolio-company level thus subjected shareholders of such companies to a level of tax that did not apply to wealthy individuals who could create a portfolio by investing directly in corporate stock.

Proponents of the RIC tax regime argued that favorable tax treatment for investment trusts would allow smaller investors to invest in portfolio companies and obtain the same position that wealthy investors could obtain through direct investment.⁵⁸ The RIC tax regime thus made portfolio investment a viable reality for a larger portion of the population, and for a greater section of middle-income investors in particular.⁵⁹ At the end of 2013, around 46% of U.S. households owned mutual funds,⁶⁰ which are a type of RIC, so the RIC tax regime benefits a very significant portion of the population and makes portfolio investment a reality for a broader section of the population. The 46% of the population mostly includes the top half of the population based upon income level.⁶¹ The rules therefore do not appear to significantly help the most vulnerable members of society increase or diversify savings,

1481–83 (discussing the tax classification of investments trusts in the 1930s and extra cost imposed by the tax classification of mutual funds).

57. See Morley, *supra* note 42, at 356–57.

58. See *Revenue Act of 1936: Hearings on H.R. 12395 Before the S. Comm. on Fin.*, 74th Cong. 776–77 (1936) (statement of John Sherman Myers); Consuelo L. Kertz & Paul J. Simko, *Mutual Fund Investing and Tax Uncertainty: The Need for New Disclosures*, 7 STAN. J.L. BUS. & FIN. 103, 107 (2001) (recognizing that RICs also allow small investors to obtain expert investment advice).

59. See S. REP. NO. 73-1455, at 348–51 (1934); Samuel D. Brunson, *Mutual Funds, Fairness, and the Income Gap*, 65 ALA. L. REV. 139, 140–41 (2013); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 20 (1991) (“Mutual funds are designed for unsophisticated investors who cannot assemble a diversified portfolio or evaluate the mutual fund’s portfolio.”).

60. See *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet*, 2013, ICI RES. PERSP., Oct. 2013, at 1, <http://www.ici.org/pdf/per19-09.pdf>.

61. Only 23% of households with less than \$50,000 of annual income held mutual funds, while 69% of households with income greater than \$50,000 held mutual funds. *Id.* at 7. The typical amount of savings and investment for households with less than \$50,000 of income was \$7,500, while the typical savings and investments was \$200,000 for households with more than \$50,000 of income. *Id.* The median U.S. household income was \$51,939 in 2013. See CARMEN DENAVAS-WALT & BERNADETTE D. PROCTOR, U.S. DEPT OF COMMERCE, *INCOME AND POVERTY IN THE UNITED STATES: 2013*, at 5 (2014), <http://www.census.gov/content/dam/Census/library/publications/2014/demo/p60-249.pdf>.

but they do help the middle-income portion of the population diversify savings.

REIT taxation is modeled after the RIC tax regime.⁶² Prior to the enactment of the RIC regime, real estate trusts held real property,⁶³ but the real-estate-trust industry apparently was not sufficiently organized or motivated to join the mutual fund industry to obtain favorable tax treatment in the 1930s.⁶⁴ That inability to eliminate the double tax on the income of real estate trusts was attributed with hobbling the real-estate-trust industry and hampering its contributions to the growth of the national economy.⁶⁵ Nonetheless, the industry eventually gathered itself and made a push to obtain favorable tax treatment for real estate trusts.⁶⁶ The arguments in support of favorable tax treatment for real estate trusts, as reported by the House of Representatives, included “equality of tax treatment between the beneficiaries of real estate trusts and shareholders of regulated investment companies” and an expansion of investment “advantages normally available only to those with larger resources.”⁶⁷ The proponents of the legislation also contended that favorable tax treatment would help channel private funds to the real estate market.⁶⁸

62. See H.R. REP. NO. 86-2020, at 3-4 (1960) (providing that the REIT tax regime would create equality between investors in pools of real estate and securities).

63. See Laurence M. Channing, *Federal Taxation of the Income of Real Estate Investment Companies*, 36 TAXES 502, 502 (1958) (“Before securities investment trusts became a factor in the economy there were many real estate trusts (and a few corporations) organized as investment media in real estate (principally in Massachusetts), owned by substantial numbers of people and with transferrable shares enjoying active markets.”).

64. See THEODORE S. LYNN, MICAH W. BLOOMFIELD & DAVID W. LOWDEN, *REAL ESTATE INVESTMENT TRUSTS* § 1:11 (2015) (“Whatever the reason—that the respective positions were different, belief that success was unlikely, or lack of need due to absence of taxable income—REITs did not seek and were not afforded conduit tax treatment when RICs were.”).

65. See Channing, *supra* note 63, at 503 (“It would seem that the failure of real estate investment trusts to grow and contribute more to the national economic life is due in substantial part to the double tax to which their income is subjected.”).

66. See Lynn, *supra* note 27, at 78-79.

67. H.R. REP. NO. 84-2842, at 4 (1956) (“These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.”).

68. *Id.* (“[Favorable tax treatment for real estate trusts] is particularly important at the present time because of the countrywide complaints about the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories, and hotels. At the present time the financing of these real estate equities and mortgages is dependent largely on Government-guaranteed money, and investments by special groups, such as insurance companies and pension trusts.”); LYNN, BLOOMFIELD & LOWDEN, *supra* note 64 (“The proponents of REIT legislation

Nonetheless, Congress was careful to point out that favorable taxation would be extended only to real estate arrangements that, to the extent possible, were subject to the requirements and conditions that applied to RICs.⁶⁹ It also made certain to clarify that the favorable tax treatment would only extend to passive investments in real estate.⁷⁰ Thus, the proponents of favorable REIT legislation framed their arguments in terms of equity and economic expediency—they argued that real estate (and its investors) should benefit from the same tax treatment afforded to RICs (and their investors) and that favorable REIT tax treatment would help stimulate the economy. They also ensured that REITs would be different from active businesses that were subject to corporate tax, drawing a distinction to justify equal treatment with RICs and different treatment from tax corporations.

Favorable tax provisions for REITs appeared in two separate legislative proposals in 1956 and 1957.⁷¹ Both times the House and Senate voted to enact the bills, but President Eisenhower vetoed the 1956 proposal,⁷² and the two legislative bodies could not agree on various aspects of provisions in a 1957 proposal, which was ultimately rejected by the Conference Committee.⁷³ A few years

argued to developers and to the real estate industry that passage of such legislation would lead to a rise in the value of property and that the ranks of potential buyers would be increased. The proponents also argued to various government agencies that REIT legislation would be a boon to urban renewal and would produce more 'Golden Triangles.'"). Proponents of subsequent REIT legislation raised the same arguments. See, e.g., 131 CONG. REC. 12,796 (1985) (statement of Rep. Vander Jagt) ("The purpose of the legislation was to provide an opportunity for small investors to obtain the advantages of real estate investment normally available only to those with much greater resources The product of [the REIT] tax regime is a mechanism for small investors to combine their resources for investment in a diversified pool of real estate assets under professional management, while enjoying the benefits of liquidity represented by transferable securities having the attributes of corporate stock.").

69. See H.R. REP. NO. 84-2842, at 4.

70. See *id.* ("[The House Ways and Means Committee] has also taken care to draw a sharp line between passive investments and the active operation of businesses, and has extended the conduit type of tax treatment only to the passive investments of real estate trusts. [The Committee] believes that any real estate trust engaging in active business operations should continue to be subject to the corporate tax in the same manner as is true in the case of similar operations carried on by other comparable enterprises.").

71. See H.R. 4392, 84th Cong. (1956); H.R. 8102, 85th Cong. (1957). The Senate passed a slightly different version of the 1957 proposal. See S. REP. NO. 85-1983, at 65 (1958); LYNN, BLOOMFIELD & LOWDEN, *supra* note 64.

72. See 102 CONG. REC. 15,304-05 (1956) (Dwight D. Eisenhower's veto message dated Aug. 10, 1956); see also *Memorandum of Disapproval of Bill Providing a Special Method of Taxation of Real Estate Investment Trusts*, AM. PRESIDENCY PROJECT (Aug. 10, 1956), <http://www.presidency.ucsb.edu/ws/index.php?pid=10575&st=4392&st1=1>.

73. See H.R. REP. NO. 85-2632, at 30 (1958) (Conf. Rep.).

later, with a change of personnel at Treasury,⁷⁴ the President appeared to have a change of heart and signed the first REIT bill into law in 1960.⁷⁵ Although President Eisenhower ultimately signed the REIT legislation into law, his reasons for originally vetoing it resonate in the current environment of real estate spinoffs, REIT conversions, and the evolving applications of REIT taxation. They also echo in arguments presented today as a basis for REIT reform. First, President Eisenhower recognized that the income of RICs differed from the income of real estate trusts. In particular, the income of RICs “generally derive[s] from the securities of corporations which are fully subject to corporate income tax” and the conduit treatment afforded to RICs “merely avoids an additional level of corporate taxation.”⁷⁶ The President observed that by contrast, conduit treatment for real estate trusts “would entirely remove the corporate income tax from much of the income originating in their real estate operations.”⁷⁷ He was also concerned that although REIT taxation was “intended to be applicable only to a small number of trusts, it could, and might well become, available to many real-estate companies which were originally organized and have always carried on their activities as fully taxable corporations.”⁷⁸ The President therefore appeared to adequately address the parallel with RICs, and he very presciently identified how REITs might grow and potentially erode the corporate tax base. The issues that existed at the time REIT taxation became the law still exist today. Even though President Eisenhower signed REIT legislation into law a few short years following the veto letter, proponents of REIT reform still rely upon the reasons set forth in the veto letter as grounds for reforming the REIT regime.⁷⁹

74. See LYNN, BLOOMFIELD & LOWDEN, *supra* note 64 (claiming that Dan Throop Smith, Undersecretary for Tax Policy of the Treasury, was the main source of resistance to the REIT legislation, and after he resigned in 1959, the president signed the legislation into law).

75. See Act of Sept. 14, 1960, Pub. L. No. 86-779, § 10(a), 74 Stat. 98, 1003–08 (1960); *History of REITs*, NAREIT, <https://www.reit.com/investing/reit-basics/history-reits> (last visited Sept. 18, 2015); Brad Thomas, *Eisenhower Paved the Way for REIT Investors to Enjoy Durable Dividends*, FORBES (Dec. 12, 2012, 5:54 AM), <http://www.forbes.com/sites/bradthomas/2012/12/12/eisenhower-paved-the-way-for-reit-investors-to-enjoy-durable-dividends/>.

76. 102 CONG. REC. 15,304–05 (1956); see *supra* text accompanying notes 57–58 (describing the third level of tax).

77. 102 CONG. REC. 15,304–05 (1956).

78. *Id.*

79. See Tax Reform Act of 2014, H.R. 1, 113th Cong. (indicating that Congress did not intend REITs to erode the corporate tax base); sources cited *supra* note 3; Sullivan, *supra* note 16, at 1105–07 (focusing on corporate tax lost as a result of REIT spinoffs and conversions).

In addition to repeating the earlier arguments for favorable REIT taxation, the legislative history accompanying the 1960 act addressed the President's original misgivings about the legislation. In particular, it noted that the only income of a RIC that previously had been subjected to income tax was corporate dividends, while the interest income and capital gains of a RIC were not subject to tax prior to being recognized by the RIC.⁸⁰ Consequently, some RIC income was not subject to an entity-level tax, and so, the argument went, excluding REIT income from entity-level taxation was fair. The argument also provided that interest income of RICs is an important element of their portfolios, confirming that the number of specified levels of taxes with respect to the income of the RIC is not the justification for favorable RIC taxation.⁸¹ Instead, the primary justification for favorable RIC taxation was to "accord individuals of small means an opportunity to pool their investments in one of these companies, yet receive the same treatment as those of greater wealth can obtain by direct investments."⁸² Similarly, providing an opportunity to small investors in real estate markets became a key purpose of the REIT legislation in 1960.⁸³ The following discussion illustrates that as proponents of the REIT regime sought to change the law over the years, they often echoed these original purposes. Nonetheless, the current REIT regime is significantly different from the one originally enacted by Congress. Some of the changes may not reflect Congress's originally stated purpose.

B. Original REIT Regime (1960)

Many of the basic components of the current REIT requirements reflect the original law enacted in 1960, but changes over the last twenty-five years or so have significantly changed the scope of REIT taxation, as predicted by President Eisenhower when he vetoed the first REIT proposed legislation. Tax law generally treats REITs like tax corporations, but it grants REITs a deduction for dividends paid to shareholders.⁸⁴ The deduction for dividends paid generally eliminates the double tax, but taxable-REIT shareholders must pay tax on the REIT's distributed

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

81. *Id.* at 4.

82. *Id.*

83. *Id.* at 3.

84. See I.R.C. § 857(b)(1), (b)(2)(B) (2012). Tax law treats REITs differently from tax corporations in other ways, see § 857(b), but the deduction for dividends is the most significant because it generally allows REITs to avoid the corporate double taxation.

income.⁸⁵ To qualify for the dividend-paid deduction, a qualifying entity must elect to be a REIT and distribute at least 90% of its taxable income each taxable year.⁸⁶ To be treated as a REIT, the entity must satisfy an organizational test, assets tests, and income tests.⁸⁷

1. *Organizational Test.* Originally a REIT had to be a state-law trust or other unincorporated association,⁸⁸ but today, a REIT can be a state-law corporation, trust, or association (which include state-law partnerships and limited liability companies), as long as it satisfies several requirements.⁸⁹ To begin, a REIT must be managed by one or more trustees or directors.⁹⁰ The ownership of a REIT must be evidenced by transferable shares or certificates of beneficial interests,⁹¹ the interests must be held by 100 or more persons,⁹² and generally the REIT ownership cannot be highly concentrated in a small number of investors (i.e., closely held).⁹³

85. § 61(a)(7) (including dividends in gross income); § 301(c) (distinguishing various portions of dividends); § 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); Treas. Reg. § 1.857-6 (as amended in 1986) (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 § 501(a) (exempting organizations such as charities, churches, educational institutions, and retirement funds from taxation); § 512(b)(1) (excluding dividends from the definition of unrelated business taxable income); Rev. Rul. 66-106, 1966-1 C.B. 151 (ruling that REIT dividends paid to an exempt employees' pension trust do not constitute unrelated business taxable income). But see § 856(h)(3) (subjecting some dividends paid from pension-held REITs to certain pension trusts to unrelated business taxable income).

86. § 857(a)(1). This requirement was part of the original REIT statute. See Act of Sept. 14, 1960, Pub. L. No. 86-779, sec. 10(a), § 857(a)(1), 74 Stat. 98, 1006 (1960) (codified at I.R.C. § 857(a)(1) (Supp. II 1961)). Congress adopted it to reflect the conduit type of tax treatment that it had granted to RICs. See H.R. REP. NO. 86-2020, at 8 (1960).

87. To qualify as a REIT, an entity also must satisfy a filing requirement. See § 856(c)(1). It also must ascertain its ownership each year. See § 857(f).

88. See sec. 10(a), § 856(a), 74 Stat. at 1004 (codified at I.R.C. § 856(a) (Supp. II 1961)).

89. See § 856(a). A partnership or limited liability company can elect to be a tax corporation, so they too can be REITs. See Treas. Reg. § 301.7701-1 to -3 (2012).

90. § 856(a)(1). Originally, the law limited management to trustees to reflect the requirement that a REIT generally be a trust. See sec. 10(a), § 856(a), 74 Stat. at 1004 (codified at I.R.C. § 856(a) (Supp. II 1961)).

91. § 856(a)(2). This rule is the same as the original rule. See sec. 10(a), § 856(a)(2), 74 Stat. at 1004 (codified at I.R.C. § 856(a)(2) (Supp. II 1961)).

92. § 856(a)(5). This rule is the same as the original rule. See sec. 10(a), § 856(a)(5), 74 Stat. at 1004 (codified at I.R.C. § 856(a)(5) (Supp. II 1961)).

93. § 856(a)(6). This rule differs slightly from the original rule, which required that REITs not be personal holding companies if all of their income constituted personal-holding-company income. See sec. 10(a), § 856(a)(6), 74 Stat. at 1004 (codified at I.R.C. § 856(a)(6) (Supp. II 1961)). The current REIT requirements incorporate the

As a general matter, an arrangement is closely held, and thus could not satisfy the organizational test, if during the last half of the year not more than five individuals own more than 50% of the value of the entity's outstanding stock.⁹⁴ Congress originally conditioned REIT classification on real estate trusts not holding property primarily for sale to customers in the ordinary course of their trades or businesses.⁹⁵ Today, the statute preserves that policy goal by having the income tests exclude the gains from the sale of such property from the list of qualifying income,⁹⁶ and by imposing a 100% penalty tax on the gains (without offset by losses) from the sale of such property.⁹⁷ Finally, a REIT cannot be a financial institution or insurance company, and it must otherwise be classified as a tax corporation.⁹⁸

2. *Asset Tests.* Today, as with the original REIT regime, at least 75% of a REIT's assets must consist of real estate assets, cash and cash items, and government securities.⁹⁹ Both the current and original regimes defined real estate assets to include real property, interests in real property and mortgages on real property, and shares in other REITs.¹⁰⁰ The current regime also includes stock or debt instruments that do not otherwise come within the definition of real estate assets, but that the REIT holds as a temporary investment of new capital.¹⁰¹ Real property includes land and improvements thereon,¹⁰² and interests in real property include fee ownership, co-ownership, leaseholds, and options to acquire real property and interests in real property.¹⁰³ The

personal-holding-company definition of closely held, but does not adopt the rules related to personal-holding-company income. See § 856(h)(1)(A).

94. See §§ 856(h)(1)(A), 542(a)(2), 857(f).

95. See sec. 10(a), § 856(a)(4), 74 Stat. at 1004 (codified at I.R.C. § 856(a)(4) (Supp. II 1961)).

96. See *infra* text accompanying note 115.

97. See § 857(b)(6).

98. See § 856(a)(3), (4); *supra* note 89 and accompanying text (describing how several state-law entities can be classified as tax corporations). The original rule required REITs to otherwise come within the definition of corporation, but did not prohibit them from being a financial institution or insurance company. See sec. 10(a), § 856(a)(3), 74 Stat. at 1004 (codified at I.R.C. § 856(a)(3) (Supp. II 1961)).

99. Compare § 856(c)(4)(A), with sec. 10(a), § 856(c)(5)(A), 74 Stat. at 1004 (codified at I.R.C. § 856(c)(5)(A) (Supp. II 1961)).

100. Compare § 856(c)(5)(B), with sec. 10(a), § 856(c)(6)(B), 74 Stat. at 1005 (codified at I.R.C. § 856(c)(6)(B) (Supp. II 1961)).

101. See § 856(c)(5)(B) (providing that the investment is temporary if the REIT does not hold it for more than one year after receiving the new capital).

102. See Treas. Reg. § 1.856-3(d) (2014).

103. § 856(c)(5)(C).

definition of real property has been the subject of numerous rulings, which clarify the definition as the needs and use of real estate in the economy have changed over time.¹⁰⁴ The current definition of interests in real property includes options to acquire real property and leaseholds in real property, but the original definition did not.¹⁰⁵ Both versions of the definition exclude mineral, oil, and gas royalty interests.¹⁰⁶

The current REIT regime also includes a diversification requirement that largely survives from the original version.¹⁰⁷ A REIT can hold only a limited amount of non-real estate assets. For example, not more than 25% of its assets (in value) can be nongovernmental securities and not more than 25% of its assets (in value) can be securities in taxable REIT subsidiaries.¹⁰⁸ Generally, not more than 5% of the REIT's assets (in value) can be represented by the securities of one issuer.¹⁰⁹ Finally, a REIT cannot hold more than 10% (in vote and in value) of the outstanding securities of any one issuer.¹¹⁰ Congress designed these rules to ensure diversification of nonqualifying assets to reflect similar diversification requirements in the RIC regime.¹¹¹ Because REITs can still concentrate all of their investment in a single real estate asset, the diversification requirement generally has little effect on most REITs, so the application of the diversification requirement to REITs is significantly different from application to RICs.¹¹²

3. *Income Tests.* Both the original and current REIT rules limit the types of income that a REIT may have, but, as this brief

104. See *infra* Part II.C.8 (discussing the definition of real property).

105. Compare § 856(c)(5)(C), with sec. 10(a), § 856(c)(6)(C), 74 Stat. at 1005 (codified at I.R.C. § 856(c)(6)(C) (Supp. II 1961)).

106. Compare § 856(c)(5)(C), with sec. 10(a), § 856(c)(6)(C), 74 Stat. at 1005 (codified at I.R.C. § 856(c)(6)(C) (Supp. II 1961)).

107. Compare § 856(c)(4)(B), with sec. 10(a), § 856(c)(5)(B), 74 Stat. at 1004–05 (codified at I.R.C. § 856(c)(5)(B) (Supp. II 1961)).

108. See § 856(c)(4)(B)(i), (ii). Because Congress did not enact the taxable REIT subsidiary rules until 1999, the original REIT regime obviously did not include rules limiting the value of the REIT's assets that could be attributed to taxable REIT subsidiaries. See *infra* Part II.C.6.

109. See § 856(c)(4)(B)(iii)(I). Government securities and securities in taxable REIT subsidiaries are not subject to this rule. See § 856(c)(4).

110. See § 856(c)(4)(B)(iii)(II), (III).

111. See H.R. REP. NO. 86-2020, at 6 (1960); *supra* text accompanying note 49 (describing the RIC diversification requirement).

112. See Carroll, *supra* note 27, at 344 (recognizing that the result of a RIC concentrating the bulk of its investment in securities of a single industry is not the same as a REIT concentrating the bulk of its investment in real estate).

discussion illustrates, the two regimes are slightly different. Under the current rules, a REIT must satisfy both a 75% gross income test and a 95% gross income test (up from the 90% in the original test).¹¹³ The original and current income tests require that at least 75% of the REIT's gross income derive from the following types of income: (1) rents from real property, (2) interest from obligations secured by mortgages on real property, (3) gain from the sale of real property (including mortgages on real property), (4) dividend income from other REITs and gain from the sale of interests in other REITs, and (5) abatements and refunds on real property.¹¹⁴ The law now specifically excludes from the qualifying list any gain from property held primarily for sale to customers in the ordinary course of the REIT's trade or business and adds the following items as permitted sources of income: (1) income and gain derived from foreclosure property, (2) amounts received to enter into loans or real estate contracts, (3) gains from the sale of certain real estate assets that are not prohibited transactions, and (4) qualified temporary investment income.¹¹⁵ The 95% gross income test requires that at least 95% of the REIT's gross income derive from the sources in the 75% test, dividends, interest, or capital gains on securities.¹¹⁶ Thus, the income test helps ensure that REIT income is mostly from passive sources.

A REIT can satisfy the income tests if it holds only mortgages because interest on obligations secured by mortgages on real property and gains from sales of non-inventory mortgages on real property are permitted types of income under the income tests.¹¹⁷ If the entity holds only mortgages secured by real property, it will

113. Compare § 856(c)(2), (3), with sec. 10(a), § 856(c)(2), (3), 74 Stat. at 1004 (codified at I.R.C. § 856(c)(2), (3) (Supp. II 1961)). Cross-border treaty rules may, however, require diversification of the real estate owned by a REIT as a prerequisite to obtaining favorable treaty rates on dividends from U.S. REITs. See, e.g., United States Model Income Tax Convention of November 15, 2006, art. 10(2)(b), (3), (4)(a)(iii), reprinted in 1 TAX TREATIES (CCH) ¶ 209, at 10,553.

114. Compare § 856(c)(3)(A)–(E), with sec. 10(a), § 856(c)(3), 74 Stat. at 1004 (codified at I.R.C. § 856(c)(3) (Supp. II 1961)).

115. See § 856(c)(3)(F)–(I). Prohibited transactions are defined in § 857(b)(6), and temporary investment income is defined in § 856(c)(5)(D). The qualifying list excludes property held primarily for sale to customers in the ordinary course of a trade or business by incorporating the definition from § 1221(a)(1). See § 856(c)(3)(C). The original version of the statute included that prohibition on dealer property in the organizational test. See *supra* text accompanying note 95.

116. See § 856(c)(2). Originally, the statute only required 90% of the REIT's income to satisfy the test. See sec. 10(a), § 856(c)(2), 74 Stat. at 1004 (codified at I.R.C. § 856(c)(2) (Supp. II 1961)). But Congress raised the limit to 95% in 1976. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 1604(a), 90 Stat. 1520, 1749 (codified at I.R.C. § 856(c)(2) (1976)).

117. See § 856(c)(3)(B)–(C).

also satisfy the 95%-income test, which recognizes interest as a permitted type of income.¹¹⁸ A REIT may also acquire and dispose of mortgages, if the extent of the activity does not cause the REIT to become a dealer and the mortgages to become inventory.¹¹⁹

From the outset, the definition of rents from real property has been an important part of the income tests, as the primary source of income for equity REITs will be rents from real property.¹²⁰ The exclusions from the definition generally receive more attention than the general definition. The original definition provided that rents from real property included “rents from interests in real property.”¹²¹ It also excluded three types of receipts: (1) amounts that depend in whole or in part on the income or profits derived by any person from the property,¹²² (2) amounts received from any person controlled by the REIT,¹²³ and (3) amounts received for services rendered by the REIT to tenants or from managing or operating the property.¹²⁴ The third exclusion did, however, permit the REIT to provide the services through an independent contractor, so long as the REIT did not receive or derive any

118. See § 856(c)(2)(B). REITs formed to acquire or issue residential mortgage-backed securities (RMBS) in years leading up to the 2008 financial crisis may not satisfy the asset or income tests. For example, in many situations in recent years, RMBS entities did not appear to acquire mortgages. See Bradley T. Borden & David J. Reiss, *REMIC Tax Enforcement as Financial-Market Regulator*, 16 U. PA. J. BUS. L. 663, 694–715 (2014). Instead, they appeared to receive payments pursuant to a pooling and service agreement entered into with several other parties. See *id.* at 715–16. The rights under the pooling and servicing agreement may not qualify as mortgages. See *id.* at 716. Courts are still considering who holds security interests in mortgages that were a part of the MERS system, many of which mortgages were part of pooling and servicing agreements. See *id.* at 726–28. Consequently, some assets that mortgage REITs hold may not come within the definition of mortgages on real property and the income such REITs received may not come within the definition of interest on obligations secured by mortgages on real property.

119. Gains from the sale of inventory are prohibited transactions subject to a 100% tax, but which do not count against the income test. See § 856(c)(2)(D), (3)(D) (excluding from REIT-qualifying income gain from the sale of property held primarily for sale to customers in the ordinary course of a trade or business); § 857(b)(6) (imposing a tax on gain from the sale of property described in § 1221(a)(1), which included inventory).

120. See, e.g., Zivot, *supra* note 27, at 57–69 (recounting the evolution of the definition of rents from real property and the integral role it plays in the REIT tax regime); Carroll, *supra* note 27, at 325–38 (discussing the definition and policy aspects of the definition); Harvard Note, *supra* note 27, at 1118, 1126 (recognizing that the definition of rents from real property helps ensure that REIT income is passive).

121. Sec. 10(a), § 856(d), 74 Stat. at 1005 (codified at I.R.C. § 856(d) (Supp. II. 1961)).

122. Sec. 10(a), § 856(d)(1), 74 Stat. at 1005 (codified at I.R.C. § 856(d)(1) (Supp. II 1961)).

123. See sec. 10(a), § 856(d)(2), 74 Stat. at 1005–06 (codified at I.R.C. § 856(d)(2) (Supp. II 1961)) (defining control as a 10% ownership by the REIT).

124. Sec. 10(a), § 856(d)(3), 74 Stat. at 1006 (codified at I.R.C. § 856(d)(3) (Supp. II 1961)).

income from those services.¹²⁵ Each of the exceptions to the definition of rents from real property is designed to ensure that REITs do not derive income from the active conduct of a trade or business.¹²⁶ Congress therefore used these exceptions to ensure that REIT income derived from passive sources. If income associated with real property does not come within the definition of rents from real property, it will count against the income tests.¹²⁷ The first two exceptions to the definition have remained largely unchanged, but, as the discussion below illustrates, the third exception has narrowed significantly, expanding the definition of rents from real property and liberalizing the types of services a REIT can perform.¹²⁸

In summary, tax law grants REITs a form of conduit treatment, but it imposes specific organizational requirements and restricts the types of assets REITs can hold and the types of income they can earn. As a general matter, a significant portion of a REIT's assets must be real estate assets, and most of its income must derive from such assets. A REIT may buy and sell real estate assets, but for the most part a REIT cannot be active in buying and selling real estate assets because gain from such sale is excluded from the lists of permitted income,¹²⁹ and such gains are subject to a 100% tax.¹³⁰

In 1960, failure to meet any of the tests meant that the entity could not qualify for REIT taxation, and all of the entity's taxable income was subject to an entity-level tax, with no dividend-paid deduction.¹³¹ Subsequent changes have moved away from that

125. See sec. 10(a), § 856(d)(3), 74 Stat. at 1006 (codified at I.R.C. § 856(d)(3) (Supp. II 1961) (defining independent contractor as any person who does not own more than 35% of the REIT beneficial interests and is not under 35% common control with the REIT).

126. See H.R. REP. NO. 86-2020, at 6-7 (1960) ("Th[e] interest in restricting the income of the trust to that of a passive nature also accounts for two of the restrictions [the prohibition against sharing in income or profits and the prohibition against providing tenant services or managing or operating the property] provided in the definition of 'rents from real property.'").

127. See I.R.C. § 856(d)(2)(C) (2012) (excluding impermissible tenant service income from the definition of rents from real property).

128. See § 856(d)(2)(A), (B); *infra* Parts II.C.2, II.C.6.

129. See § 856(c)(3)(C) (excluding gain from the sale of property held primarily for sale to customers in the ordinary course of a trade or business).

130. § 857(b)(6)(A).

131. See Act of Sept. 14, 1960, Pub. L. No. 86-779, sec. 10(a), §§ 856-857, 74 Stat. 98, 1004 (codified at I.R.C. §§ 856-857 (Supp. II 1961)); Carroll, *supra* note 27, at 306-13 (describing the complex nature of the different requirements and some ambiguities of each). The original act did provide some allowance from failure to meet the asset tests due to a discrepancy in the value of the REIT's assets. See sec. 10(a), § 856(c)(5), 74 Stat. at 1005 (codified at I.R.C. § 856(c)(5) (Supp. II 1961)) (flush language).

all-or-nothing treatment in favor of a regime of intermediate sanctions and have expanded the types of services a REIT can perform. Today, if a REIT fails to satisfy any of the tests in a given year, it can correct the failure and retain REIT status if the failure was due to reasonable cause and not willful neglect and it pays an intermediate sanction penalty for each failed requirement.¹³² A significant question for REITs is whether payments from tenants come within the definition of rents from real property.¹³³ A REIT can receive payments from tenants that do not come within the definition of rents from real property, but those payments will count against the income tests.¹³⁴ If the amount of such receipts from a single property exceeds 1% of the total receipts from the property, all of the receipts from the property will fail to come within the definition of rents from real property and will jeopardize the REIT's status.¹³⁵

C. *Evolution of REIT Taxation*

In the years that have followed the enactment of the original REIT legislation, the rules governing REIT classification have changed in many ways, making REIT taxation available to more diverse investors and a much wider swath of property than was held by real estate trusts in 1960. Now institutional investors can own all of the stock of REITs,¹³⁶ REITs have lower distribution obligations,¹³⁷ and they can provide more services.¹³⁸ Various structures also make REIT ownership and management much easier.

1. *Foreclosure Property and Mortgage REITs (1975).* The original REIT legislation included interests in mortgages in the definition of real estate assets.¹³⁹ From early on, mortgage REITs were a part of total REIT market capitalization.¹⁴⁰ Nonetheless, the prohibition against holding property primarily for sale to

132. See § 856(g)(1), (5); § 856(c)(7)(A), (C); § 857(b)(5); § 860; see also Treas. Reg. § 1.857-11 (2014) (applying § 852(e) to REITs).

133. See *infra* Parts II.C.2, II.C.6. (discussing how services may affect whether payments from tenants are rent from real property).

134. See § 856(d)(2)(C); (d)(7).

135. See § 856(d)(7)(B); Rev. Rul. 98-60, 1998-2 C.B. 751.

136. See *infra* Part II.C.4.

137. See *infra* Part II.C.5.

138. See *infra* Parts II.C.2, II.C.6.

139. See Act of Sept. 14, 1960, Pub. L. No. 86-779, sec. 10(a), § 856(c)(6)(B), 74 Stat. 98, 1005 (codified at I.R.C. § 856(c)(6)(B) (Supp. II 1961)).

140. See *infra* Appendix A.

customers in the ordinary course of a trade or business puts mortgage REITs at a competitive disadvantage.¹⁴¹ Foreclosing on defaulting mortgages would put such REITs in possession of assets they might prefer to sell shortly after acquisition. Property disposed of shortly after acquisition could come within the definition of property held primarily for sale to customers in the ordinary course of the REIT's trade or business.¹⁴² Consequently, if a mortgage REIT foreclosed on property and shortly thereafter disposed of the property, it would have lost its REIT status if the property came within the definition of held primarily for sale to customers in the ordinary course of its trade or business.¹⁴³ With the original rules, mortgage REITs would have to choose from among three unattractive alternatives when a mortgagee defaulted on a loan: (1) not foreclose on the property and potentially lose the ability to control the collateral and preserve its value; (2) foreclose on the property and hold it long term; or (3) foreclose on the property, dispose of it shortly after foreclosure, and risk losing REIT status. The potential loss of REIT status or other bad results undoubtedly dissuaded many parties from forming mortgage REITs in the first place, because some borrowers can be expected to default and foreclosure is thus a real possibility for mortgage holders.¹⁴⁴

In 1975, Congress adopted a rule that mitigated the effect of the original rule and made mortgage REITs economically viable. The 1975 amendment provided that a real estate trust would not lose its REIT status even though it held "foreclosure property" primarily for sale to its customers in the ordinary course of its trade or business.¹⁴⁵ It defined foreclosure property generally to include any property acquired as result of a lessee or mortgagee defaulting, if the REIT elected to treat the property as foreclosure property and held it less than two years following the

141. See *supra* text accompanying note 95.

142. Whether a person holds property primarily for sale to customers in the ordinary course of a trade or business is based upon a multiple-factor facts-and-circumstances test that has no bright lines. See Bradley T. Borden, Nathan R. Brown & E. John Wagner, II, *A Case For Simpler Gain Bifurcation For Real Estate Developers*, 16 FLA. TAX REV. 279, 291–300 (2014) (describing some of the factors courts consider to determine if property comes within the definition).

143. See sec. 10(a), § 856(a)(4), 74 Stat. at 1004 (codified at I.R.C. § 856(a)(4) (Supp. II 1961)).

144. Indeed, following legislative changes discussed below, the market capitalization of mortgage REITs began an upward climb, and within a decade and half the number of mortgage REITs reached an all-time high. See *infra* Appendix A.

145. See Act of Jan. 3, 1975, Pub. L. No. 93-625, § 6(b), 88 Stat. 2108, 2112–13 (codified at I.R.C. § 856(a)(4) (Supp. V 1976)).

foreclosure.¹⁴⁶ That definition remains largely intact today,¹⁴⁷ but the current statute incorporates foreclosure property into the income test instead of making it a part of the organizational test.¹⁴⁸ Even though Congress allows REITs to hold and sell foreclosure property, it requires REITs to pay entity-level taxes at regular corporate rates on gains from the disposition of such property.¹⁴⁹

Rules governing certain types of mortgage REITs changed further in 1986 when Congress enacted a new regime governing certain types of mortgage pools. In 1986, Congress created a tax regime for real estate mortgage investment conduits (REMICs) providing flow-through taxation to mortgage pools that issue multiple classes of multiple-maturity securities.¹⁵⁰ It also provided that interests in REMICs come within the definition of real estate assets for REIT purposes,¹⁵¹ so REITs can hold REMIC interests as their sole asset class or as part of a diversified pool of real estate assets.¹⁵² The multiple classes of multiple-maturity securities (including regular and residual interests in REMICs)¹⁵³ in a mortgage pool raise complex accounting issues that the REMIC rules address.¹⁵⁴ One such rule requires the holders of residual

146. See § 6(a), 88 Stat. at 2112–13 (1975) (codified at I.R.C. § 856(e) (Supp. V 1976)).

147. See I.R.C. § 856(e) (2012).

148. See § 856(c)(2)(F), (3)(F); *supra* text accompanying note 95.

149. See § 857(b)(4). This is similar to the original rule as amended in 1975. See § 6(c), 88 Stat. at 2113 (codified at I.R.C. § 857(b)(4) (Supp. V 1976)).

150. See Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 671(a), §§ 860A–860G, 100 Stat. 2085, 2308–17 (codified at I.R.C. §§ 860A–860G (Supp. IV 1987)).

151. See § 671(b), 100 Stat. at 2317 (codified at I.R.C. § 856(c)(5)(D) (Supp. IV 1987)). The current law retains this rule. See § 856(c)(5)(E) (2012).

152. Because the REIT rules treat a REMIC interest as a real estate asset, a REIT should not jeopardize its REIT status if its sole assets are interests in a single REMIC. See § 856(c)(5)(E), (c)(4) (providing that a REMIC interest is a real estate asset, and applying the diversification rules only to securities that do not come within the definition of real estate asset).

153. See § 860D(a)(2).

154. See § 860B (setting forth the rules governing the tax treatment of holders of REMIC regular interests); § 860C (setting forth the rules governing the tax treatment of holders REMIC residual interests); § 860E (requiring residual interest holders to recognize excess inclusions); § 860F (imposing a 100% tax on certain prohibited transactions); *see also* STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 411–12 (Comm. Print 1987) (“Holders of ‘regular interests’ generally take into income that portion of the income of the REMIC that would be recognized by an accrual method holder of a debt instrument that had the same terms as the particular regular interest; holders of ‘residual interests’ take into account all of the net income of the REMIC that is not taken into account by the holders of the regular interests.”); JAMES E. PEASLEE & DAVID Z. NIRENBERG, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS AND RELATED TOPICS, 826–85 (describing the tax treatment of REMICs and holders of REMIC interests); Borden & Reiss, *supra* note 118, at 669–76 (recounting the development of the REMIC rules and the need for the complex accounting system); Kirk Van Brunt, *Tax*

interests to recognize “excess inclusion” income.¹⁵⁵ The person who recognizes excess inclusion income cannot offset it with net operating losses¹⁵⁶ and must treat it as unrelated business taxable income if the holder is a tax-exempt entity¹⁵⁷ and is not eligible for any reduction in withholding tax (by treaty or otherwise).¹⁵⁸ The REMIC rules also generally require REITs that hold REMIC residual interests to pass any excess inclusion income through to REIT shareholders.¹⁵⁹ REITs must, however, pay tax on the excess inclusion income to the extent the excess inclusion would be allocated to a disqualified organization (i.e., one that would not otherwise pay tax on the excess inclusion income) that holds REIT stock.¹⁶⁰

Congress provided the REMIC flow-through tax rules to mortgage pools that issue multiple classes of multiple-maturity securities, meet several requirements that ensure the pool of mortgages remains static, and elect to be treated as REMICs.¹⁶¹ Other mortgage pools that issue multiple classes of multiple-maturity securities generally come within the definition of “taxable mortgage pool” (TMP) and are taxed as corporations.¹⁶² A REIT, or a REIT subsidiary, that holds a pool of mortgages would generally come within the definition of TMP,¹⁶³ but tax law appears to exempt TMP REITs from corporate taxation. In lieu of paying the corporate tax, TMP REITs must use a reasonable method to calculate excess inclusion income, allocate it to their (non-disqualified organization) shareholders in proportion to dividends paid, pay tax on any excess inclusion income allocated to disqualified organizations, and withhold the appropriate tax on

Aspects of REMIC Residual Interests, 2 FLA. TAX REV. 149, 154–56 (1994) (describing how cash flows into and out of REMICs do not match tax aspects of those flows); Bruce Kayle, *Where Has All the Income Gone? The Mysterious Relocation of Interest and Principal in Coupon Stripping and Related Transactions*, 7 VA. TAX REV. 303, 348 (1987) (describing why holders of REMIC residual interests must recognize the difference between the income taken into account by the holders of REMIC regular interests and the income generated by the REMIC).

155. See § 860E(a)(1).

156. See § 860E(a)(3).

157. See § 860E(b).

158. See § 860G(b)(2); I.R.S. Notice 2006-97, § 2, 2006-2 C.B. 904.

159. See § 860E(d).

160. See § 860E(e)(6); Rev. Rul. 2006-58, 2006-2 C.B. 876 (illustrating the application of the excess-inclusions tax to a REIT that has a charitable remainder trust (i.e., a disqualified organization) as a shareholder).

161. See §§ 860D, 860F, 860G(a)(3).

162. See § 7701(i).

163. See § 7701(i)(3).

excess inclusion income allocated to foreign persons.¹⁶⁴ REITs can take steps, such as not issuing multiple-maturity securities, to avoid the negative tax consequences and complexities of being a TMP REIT.¹⁶⁵

Mortgage REITs provide an example of how REIT taxation has expanded beyond what Congress originally perceived as the scope of the REIT regime. Mortgage REITs raise particularly complex tax accounting and finance issues because they overlap the REMIC rules and raise the same concerns that REMICs raise. Mortgage pools made headlines in the wake of the 2008 financial crisis because they were populated with low-quality loans, to the extent they held any assets at all.¹⁶⁶ Although they received less attention than mortgage-backed securities, mortgage REITs also experienced significant difficulty during the financial crisis,¹⁶⁷ but they continue to be popular among investors and feature prominently in news stories.¹⁶⁸ They are also drawing the attention of government officials.¹⁶⁹ The complexity of mortgage REITs makes them the province of a very small segment of the financial and legal industries. Perhaps that makes them susceptible to manipulation by those who control the industry, and it certainly flies in the face one of the original purposes of the REIT regime, which was to make real estate investments available to a

164. See I.R.S. Notice 2006-97, § 5, 2006-2 C.B. 905.

165. See K. Peter Ritter, *Mortgage REITs—A Primer*, 9 J. TAX'N FIN. PRODUCTS 23, 30–31 (2011); see generally Robert H. Bergdolt & Robert J. Le Duc, *Public Nontraded Mortgage REITs—Issues and Opportunities*, 7 J. TAX'N FIN. PRODUCTS 37 (2008) (discussing securities and tax issues raised by mortgage REITs).

166. See ALAN S. BLINDER, *AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD* 59–81 (2013) (describing the securitization process that led to low-quality mortgage pools); Borden & Reiss, *supra* note 118, at 669–91 (describing the role that mortgage pools played in the financial crisis); FIN. CRISIS INQUIRY COMM'N, *THE FINANCIAL CRISIS INQUIRY REPORT* 227 (2011).

167. See, e.g., Ilaina Jonas, *Mortgage REIT Woes are a Blast from the Past*, REUTERS (Aug. 15, 2007, 8:51 PM), <http://www.reuters.com/article/2007/08/16/us-mortgagereits-idUSN1526504220070816>.

168. See, e.g., Lewis Braham, *Why Mortgage REITs Deserve Some Love in 2014*, BLOOMBERG (Jan. 15, 2014, 8:49 PM), <http://www.bloomberg.com/news/2014-01-15/why-mortgage-reits-deserve-some-love-in-2014.html>; Telis Demos, *Mortgage REITs See Explosive Growth*, WALL ST. J. (Apr. 19, 2013, 1:59 PM), <http://online.wsj.com/articles/SB10001424127887324493704578432840782916034>; Stephen Gandel, *Inside the Mortgage Companies Freaking out the Fed*, FORTUNE (Feb. 19, 2013, 5:02 PM), <http://fortune.com/2013/02/19/inside-the-mortgage-companies-freaking-out-the-fed/>; Robbie Whelan, *Mortgage REITs Remain in Fed's Sights*, WALL ST. J. (Nov. 8, 2013, 2:56 PM), <http://blogs.wsj.com/economics/2013/11/08/mortgage-reits-remain-in-feds-sites/>.

169. See, e.g., SABRINA R. PELLERIN ET AL., FED. RESERVE BANK OF RICHMOND, *ASSESSING THE RISKS OF MORTGAGE REITS* 1–2 (2013), https://www.richmondfed.org/publications/research/economic_brief/2013/pdf/eb_13-11.pdf.

broader cross section of society.¹⁷⁰ The complexity of a REIT that holds pools of mortgages or mortgage-backed securities is probably beyond the comprehension of most investors, especially those with limited investment resources. Consequently, small investors would be unlikely to invest in them, except as part of a diversified portfolio.

The expansion of mortgage REITs fulfills President Eisenhower's prediction that the REIT regime would grow to encompass multiple types of arrangements that Congress could not have anticipated in 1960.¹⁷¹ Because mortgage pools can obtain flow-through treatment under the REMIC rules, mortgage REITs would not appear to draw income from corporations, so they probably do not erode the corporate tax base.

2. *Vertical Integration and Internal Management (1986).* The Tax Reform Act of 1986 was a watershed event in U.S. tax law history¹⁷² and is considered to be the most significant development in REIT taxation because it allowed REITs to move from being portfolios of real estate to becoming operating businesses that could develop and manage for their own account.¹⁷³ Prior to the 1986 Act, REITs generally could not provide direct services to tenants.¹⁷⁴ Instead, they had to hire independent contractors to provide the services.¹⁷⁵ This rule was intended to allay concerns expressed at the time of the original REIT legislation that if the law did not restrict the type of services that a REIT provided, then corporations with active businesses and some real estate, such as restaurants and hotels, would be exempt from corporate tax.¹⁷⁶

170. See *supra* text accompanying note 67.

171. See *supra* text accompanying notes 77–78.

172. See JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM* 285–89 (1987) (discussing the politics of the 1986 act and its historical significance).

173. See Constance Moore, *REIT Timeline: Celebrating 50 Years of REITs and NAREIT—Discussion of Tax Reform Act of 1986*, REIT, http://www.reit.com/time_line/videos.php?id=15.#14 (last visited Sept. 18, 2015) (explaining in a short video segment the effect of the changes in the 1986 act).

174. See *supra* text accompanying note 124.

175. See *supra* text accompanying note 125.

176. See *supra* text accompanying notes 68–70. Some commentators expressed skepticism about whether the arguments for the passive requirement were sound and attributed them to the REIT rules being modeled after the RIC rules. See, e.g., Charles D. Post & William B. King, *Final REIT Regulations Adopted; the Changes and the Effects*, 17 J. TAX'N 54, 54–55 (1962) (“It was considered that since mutual funds invested passively in stocks and bonds, only passive investment in real estate assets should receive conduit treatment. It is immaterial whether these and other assumptions were correct; the significant fact is that these assumptions are basic tenets in the theology of the legislation.”).

The restriction on the type of services that a REIT can provide also ensures that the REIT's income derives from real estate, not from services. This reflects the Congressional intent to provide preferential tax treatment to income from real estate, and not income from other sources.¹⁷⁷

The REIT industry found this rule to be too restrictive and successfully lobbied members of Congress to change the definition to include income derived from certain types of services provided by REITs.¹⁷⁸ Proponents of change, echoing arguments raised in support of the original REIT legislation,¹⁷⁹ argued that general changes to real estate taxation had presented the REIT industry with significant challenges.¹⁸⁰ They contended that Congress needed "to update the REIT tax rules and reconcile them with real estate taxation generally so that REIT[s] and their shareholders will be able to compete more effectively and to continue their important function of enhancing the flow of capital to economically viable, income-oriented real estate projects."¹⁸¹ The proponents recognized that hiring an independent contractor to provide services to tenants created agency costs that adversely affected REITs' ability to compete with other forms of real estate ownership.¹⁸² The rule evolved through the years to become more lenient, and although 1986 may have been the watershed year, changes prior to and following 1986 contribute to the more lenient approach to real estate services that exists today.

The first important change to the definition occurred in 1976. In that year, Congress expanded the definition of rents from real property to include "charges for services customarily furnished or rendered in connection with the rental of real property, whether

177. See *supra* text accompanying note 70.

178. See LYNN, BLOOMFIELD & LOWDEN, *supra* note 64, § 1:23.

179. See *supra* text accompanying notes 63–70.

180. See 131 CONG. REC. 12,796–97 (1985) (statement of Rep. Vander Jagt).

181. See 131 CONG. REC. 12,796.

182. See 131 CONG. REC. 12,797 ("It is axiomatic in the real estate industry at large that hands-on, effective management is fundamental to the successful performance of a real estate investment, and management by contractor often results in costly and unsatisfactory performance that is not in the best interests of the REIT or its shareholders. Put simply, a REIT, like any real estate investor, must have the opportunity to manage directly its investments."). Indeed subsequent studies have confirmed that externally-managed REITs underperform internally-managed REITs. See Dennis R. Capozza & Paul J. Sequin, *Debt, Agency, and Management Contracts in REITs: The External Advisor Puzzle*, 20 J. REAL EST. FIN. & ECON. 91, 98–102 (2000) (finding that externally-managed REITs underperform internally-managed REITs by 7%). Also, "[i]nformation is more transparent and symmetric in internally managed . . . REITs . . . so underwriters are willing to reduce the gross spreads for internally managed REITs." Hsuan-Chi Chen & Chiuling Lu, *How Much Do REITs Pay for Their IPOs?*, 33 J. REAL EST. FIN. & ECON. 105, 120 (2006).

or not such charges are separately stated.”¹⁸³ The stated purpose of the amendment was to help the law better reflect normal commercial practice.¹⁸⁴ The new provision did not allow REITs to provide such services. They still had to hire independent contractors to provide services and manage the property, but they no longer had to determine whether amounts they received were payment for customary tenant services.¹⁸⁵ Thus, the amendment alleviated some accounting pressure and the specter of losing REIT status if tenants made a single bundled payment to REITs, who would then pay the contractors for the services, but the amendment did not free REITs to provide services directly.

In 1986, Congress used a few words to radically update the rule for services. The amended statute allowed REITs to provide services usually rendered in connection with a leased building, by incorporating the rule that allows tax-exempt entities to provide customary tenant services to tenants of their buildings without incurring unrelated business taxable income.¹⁸⁶ A tax-exempt entity can receive rents without triggering taxable income.¹⁸⁷ The IRS has interpreted rents for this purpose to include amounts received for services “customarily rendered in connection with the rental of rooms or other space for occupancy only.”¹⁸⁸ Customary tenant services include furnishing heat and light; cleaning public entrances, exits, stairways, and lobbies; and collecting trash.¹⁸⁹ Rents do not, however, include payment for noncustomary tenant services rendered for the convenience of the occupant, such as maid services.¹⁹⁰ Therefore, the 1986 change allowed REITs to provide services directly, so long as they were customary, as provided in the 1976 amendment, and came within the definition of rents for purposes of the tax-exempt rules. The 1986 change significantly altered the management of REITs. Even though Congress changed the “overly restrictive [original rule, the change] liberalized [the

183. See Tax Reform Act of 1976, Pub. L. No. 94-455, sec. 1604(b), § 856(d)(1)(B), 90 Stat. 1520, 1749 (codified at I.R.C. § 856(d)(1)(B) (1976)).

184. See S. REP. NO. 94-938, at 474 (1976). The Senate report intended the geographic market within which a building is located to establish whether the services are customary. See S. REP. NO. 94-938, at 474.

185. See sec. 1604(b), § 856(d)(1)(B), 90 Stat. at 1749–50 (codified at I.R.C. § 856(d)(2)(C) (1976)).

186. See Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 663(a), § 856(d)(2), 100 Stat. 2085, 2302 (codified at I.R.C. § 856(d)(2) (Supp. IV 1987)) (flush language).

187. See I.R.C. § 512(b)(3) (2012).

188. See Treas. Reg. § 1.512(b)-1(c)(5) (as amended in 1992).

189. See *id.*

190. See *id.*

rule] consistent with maintaining the essential passivity of the REIT.”¹⁹¹

Subsequent statutory amendments have modified the format of the definition of rents from real property and extended permitted services to those provided by taxable REIT subsidiaries. First, in 1997, Congress simplified the language of exceptions to rents from real property by eliminating the reference to services provided by a REIT and introducing “impermissible tenant service income” as a type of receipt excluded from the definition of rents from real property.¹⁹² The definition of impermissible tenant services income incorporated the rules from earlier statutes by including services and management and operation activity provided by the REIT within the definition.¹⁹³ The new rules excluded from the definition of impermissible tenant service income (1) those services provided by an independent contractor as long as the REIT did not receive any income from those services and (2) those services that were allowed under the tax-exempt rules.¹⁹⁴ The new rules also provided that as long as the receipts from impermissible tenant services do not exceed more than 1% of the total receipts from a property, only the receipts from impermissible services will fail to be rents from real property.¹⁹⁵ First, if the receipts from impermissible services exceed the 1% threshold, then all of the receipts from the property will fail to come within the definition of rents from real property.¹⁹⁶ Second, in 1999, Congress excluded services provided by a taxable REIT subsidiary from the definition of impermissible tenant services,¹⁹⁷ subject to several rules governing taxable REIT subsidies, discussed below.¹⁹⁸

191. See STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 391 (Comm. Print 1987).

192. See I.R.C. § 856(d)(2)(C), Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1252(a), § 856(d)(2)(C), 111 Stat. 788, 1031 (codified at I.R.C. § 856(d)(2)(C) (Supp. III 1998)).

193. See sec. 1252(b), § 856(d)(7)(A), 111 Stat. at 1031-32 (codified at I.R.C. § 856(d)(7)(A) (Supp. III 1998)).

194. See sec. 1252(b), § 856(d)(7)(C), 111 Stat. at 1031-32 (codified at I.R.C. § 856(d)(7)(C) (Supp. III 1998)); *supra* text accompanying note 187-90 (describing the types of payments from services that are not taxable income to a tax-exempt).

195. See sec. 1252(b), § 856(d)(7)(C), 111 Stat. at 1031-32 (codified at I.R.C. § 856(d)(7)(C) (Supp. III 1998)).

196. See sec. 1252(b), § 856(d)(7)(B), 111 Stat. at 1032 (codified at I.R.C. § 856(d)(7)(B) (Supp. III 1998)); Rev. Rul. 98-60, 1998-2 C.B. 751.

197. See Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, sec. 542(a), § 856(d)(7)(C)(i), 113 Stat. 1860, 1941 (codified at I.R.C. § 856(d)(7)(C)(i) (Supp. IV 1999)).

198. See *infra* Part II.C.6.

A concern is that

[t]hrough all of these changes to the [impermissible tenant service income] rules over the years, the objective was primarily to bring clarity and consistency—not to change the underlying rationale for REIT rules, i.e. maintaining its passive investment status versus active. But when we look at the final results today, it seems we’ve come full circle. REITs engage in what can only be described as ‘active’ service in many of the tenant services it can now provide.¹⁹⁹

Nonetheless, the income that a taxable REIT subsidiary recognizes is subject to entity-level corporate tax, so only passive income flows through a REIT to its shareholders.²⁰⁰ One could argue that the more lenient rules appropriately made REITs more similar to limited partnerships. In fact, one commentator later recommended that the appropriate limit on services that a REIT can provide should be the services that a limited partnership provides to tenants of property it owns.²⁰¹ The reasoning for the expansive allowance of REIT services was that REIT legislation was intended to grant small investors the same access to real estate investment that large investors had, and REITs needed to provide some services to be competitive with other types of ownership structures.²⁰² To accomplish that degree of equity, the REIT rules would have to allow REITs to provide services that other real estate investors could provide to their tenants.²⁰³ As discussed below, the more liberal rules allowing REITs to provide more tenant services opened the door for tax-free REIT spinoffs.²⁰⁴ Not only did the rules reject Congress’s early concern about limiting the services a REIT can perform, they also opened the door to explicitly facilitate corporate-tax-base erosion through REIT spinoffs. Other later innovations facilitated tax-free contributions to REIT structures and the ability to raise additional capital for REITs.

3. *UPREITs (1992)*. Some of the changes in the REIT industry have occurred outside the statutory regime, having grown out of property owner innovations. UPREITs are an example of such an innovation. The UPREIT structure provides a

199. Zivot, *supra* note 27, at 66.

200. See I.R.C. § 856(l)(1) (2012) (defining taxable REIT subsidiary as a corporation that is not a REIT); *infra* Part II.C.6.

201. See Harvard Note, *supra* note 27, at 1131–34.

202. See *supra* text accompanying notes 178–82.

203. See Harvard Note, *supra* note 27, at 1132–33.

204. See *infra* text accompanying notes 301–05.

mechanism for property owners to join a REIT without incurring tax liability on the transfer of property to a REIT.²⁰⁵ The general corporate tax rules apply to REIT formations and other REIT organizational transactions.²⁰⁶ Consequently, property owners who are not part of the original ownership group of a REIT, or who experience diversification by contributing property to a REIT, would generally be subject to tax on the transfer of property to a REIT in exchange for REIT interests.²⁰⁷ Through an innovation involving the partnership tax rules rather than the corporate tax rules, the UPREIT structure allows property owners to avoid these pitfalls. If the REIT forms a partnership (commonly referred to as an umbrella partnership)²⁰⁸ of which it is the general partner and property owners transfer property to the partnership instead of to the REIT, then the transfer to the partnership can be tax-free.²⁰⁹ A REIT that is the general partner of the umbrella partnership is commonly referred to as an UPREIT (i.e., umbrella partnership REIT).²¹⁰ Figure 5 provides a basic illustration of the UPREIT structure.

205. See NAT'L ASS'N OF REAL ESTATE INV. TRUSTS, FREQUENTLY ASKED QUESTIONS ABOUT REITS 9 (2012), <https://www.reit.com/sites/default/files/portals/0/PDF/REIT-FAQ.pdf>.

206. See John P. Napoli & John F. Smith, *Emerging Issues in UPREIT Transactions*, 26 J. REAL EST. TAX'N 187, 193–96 (1999) (describing the potential taxes imposed on the contribution of real property to a REIT under the corporate tax rules).

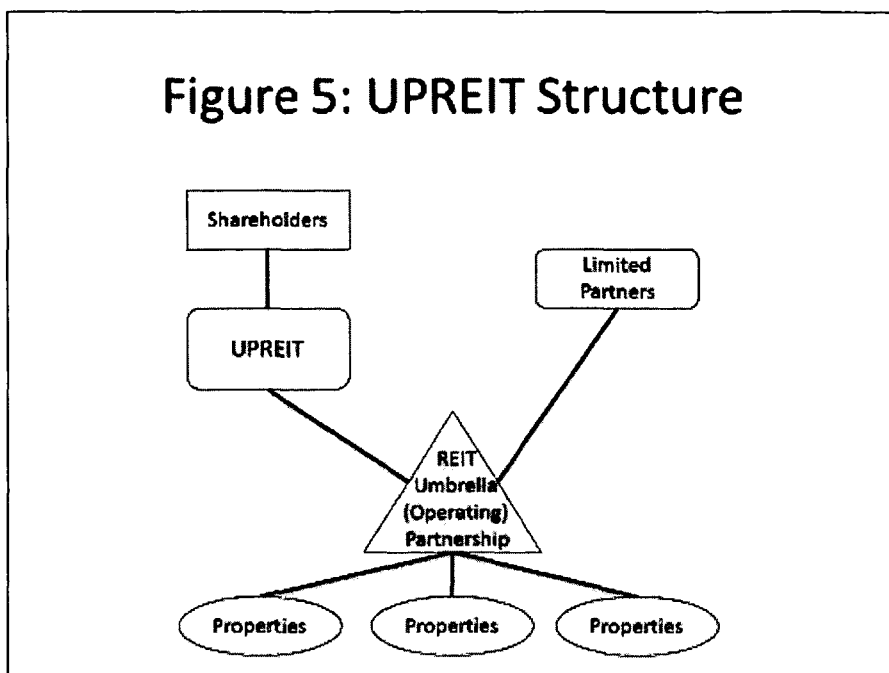
207. See I.R.C. § 351(a) (2012) (allowing nonrecognition on the transfer of property to a controlled corporation); § 368(c) (defining control as ownership of at least 80% of the vote and value of a corporation); § 351(e) (prohibiting the application of the general nonrecognition rule to transfers to investment companies); see also Treas. Reg. § 1.351-1(c)(1) (2008) (defining transfer to an investment company as a transfer to a REIT that results in diversification). Even if the general nonrecognition rule would otherwise apply, the property owners would recognize gain to the extent any contributed liability exceeded the adjusted basis of contributed property. See § 357(c); see also Blake D. Rubin, Andrea R. Macintosh & Jonathan I. Forrest, *Doing a Deal with a REIT from the Property Owner's Perspective*, 27 J. REAL. EST. TAX'N 15, 17–19 (1999) (describing the tax perils of contributing property directly to a REIT); Napoli & Smith, *supra* note 206, at 193–96.

208. See Daniel F. Cullen, *UPREITs—Structuring Fractional Interest Tender Offers*, 34 REAL EST. TAX'N 165, 165 (2007) (“The REIT is the general partner of the umbrella or operating partnership (OP), which issues one share of stock for each general partner interest . . .”).

209. See § 721(a) (granting nonrecognition to transfers of property to partnerships in exchange for partnership interests). The partnership tax rules provide that the nonrecognition does not apply to transfers of property to a partnership that comes within the definition of investment company. See § 721(b). But the IRS has sanctioned the UPREIT structure if the operating partnership does not come within the general definition of investment company. See Treas. Reg. § 1.701-2(d) (2012), *Example 4*.

210. See Cullen, *supra* note 208, at 165.

Figure 5: UPREIT Structure



For purposes of the REIT asset and income tests, the partnership interest that the UPREIT owns is treated as an interest in the umbrella partnership's underlying property, and the UPREIT's share of the partnership's income retains its character as it flows through from the umbrella partnership.²¹¹ Consequently, if the interest in the umbrella partnership is the only asset that the UPREIT owns, the assets and income of the umbrella partnership will have to satisfy the REIT asset and income tests, and the REIT must satisfy the organization test.²¹² The holders of limited partnership interests in the umbrella REIT generally have the right after the lapse of some period of time following their contribution to the umbrella partnership to put those interests into the partnership for an amount equal to the value of a comparable number of shares of UPREIT stock.²¹³ The

211. See Treas. Reg. § 1.856-3(g) (2014) (providing that the REIT is treated as owning its proportionate share of the partnership assets and gross income based upon its capital interest in the partnership).

212. See Michael K. Carnevale et al., *An Introduction to UPREITs*, 19 TAX MGMT. REAL EST. J. 3, 5 (2003) (describing that the look-through rules only relate to the REIT qualification tests, so the general allocation rules apply to determine the UPREIT's share of the partnership's taxable income); *supra* Part II.B (discussing the REIT qualification tests).

213. Richard M. Lipton, *UPREITs: Fad or Fixture?*, 71 TAXES 395, 402 n.45 (1993) (suggesting that limited partners should not be able to convert their interests to REIT stock).

umbrella partnership typically has the right to satisfy this put-right with actual UPREIT stock, which it can obtain from the UPREIT in exchange for more interest in the umbrella partnership.²¹⁴ The UPREIT structure also provides an opportunity for property owners to obtain additional capital, as was illustrated by the Taubman Centers, Inc., IPO in 1992.²¹⁵ Taubman Centers was, in fact, the first property owner to use the UPREIT structure in a REIT public offering.²¹⁶ Since then, a majority of REITs that have gone public—and nearly half of all publicly traded REITs—use the UPREIT structure.²¹⁷

The Taubman Centers structure helps illustrate how the UPREIT structure can provide capital to property owners. Taubman Centers, the UPREIT, held an interest in the umbrella partnership, which owned a portfolio of shopping centers.²¹⁸ Alfred Taubman and his partners developed and controlled the portfolio properties.²¹⁹ The UPREIT allowed Taubman to retain control of the property and raise \$295 million through an UPREIT IPO and convert debt held by pension funds into equity in the umbrella partnership without triggering capital gains.²²⁰ Within a few years after the IPO, Taubman Centers exchanged shopping centers for partnership units held by General Motors Pension Trust.²²¹ All of these transactions were accomplished tax-free.

The Taubman Centers transaction illustrates aspects of a basic UPREIT structure, but that structure is also common in other arrangements. Generally, property owners contribute

for at least one year to avoid the application of the step-transaction doctrine); Cornell, *supra* note 27, at 1578, 1589–91.

214. Telephone interview with Ameek Ashok Ponda, Partner & Dir. of Tax Dep't, Sullivan & Worchester (June 2, 2015) [hereinafter Ponda Interview].

215. See Anna Robaton, *Taubman Centers Lifts Up REITs*, REIT, Nov.–Dec. 2011, at 1, http://investors.taubman.com/files/doc_events/interviews/1-29318204_final_REIT_Magazine_eprint.pdf.

216. See Rubin, Macintosh & Forrest, *supra* note 207, at 16; Taubman Ctrs., Inc., Registration Statement (Form S-11) (Nov. 20, 1992).

217. See Brent W. Ambrose & Peter Linneman, *The Maturing of REITs*, 3 WHARTON REAL EST. REV. 37, 40 (1999) (claiming that UPREITs accounted for 77% of the REIT equity market capitalization); Steven D. Dolvin & Mark K. Pyles, *REIT IPOs and the Cost of Going Public*, 39 J. REAL EST. FIN. & ECON. 92, 97 (2009) (reporting that 65% of the REIT IPOs after 1992 were UPREITs); Feng, Price & Sirmans, *supra* note 14, at 316 (reporting that 73% of publicly held equity REITs and 67% of all REITs (public and private) are UPREITs); Rubin, Macintosh & Forrest, *supra* note 207, at 16 (citing Philip S. Payne, *UPREIT Conversions: Issues and Opportunities*, REIT REP., Autumn 1998, at 54).

218. See Ambrose & Linneman, *supra* note 217, at 40.

219. See *id.*

220. See *id.*

221. See *id.*

property to the umbrella partnership in exchange for limited partnership interests.²²² A newly formed UPREIT simultaneously raises money in an IPO and contributes the money to the umbrella partnership.²²³ The umbrella partnership generally uses the money to pay down liabilities on the property, acquire additional property, or saves the money for future acquisitions.²²⁴ The limited partners generally have the right to exchange their limited-partner interests for equivalent value in UPREIT stock (and in practice, the umbrella partnership obtains, and satisfies this claim with, actual UPREIT stock),²²⁵ but securities laws generally require the limited partners to wait at least one year to convert their interests to UPREIT stock.²²⁶ The conversion of partnership interests to UPREIT stock would be a taxable event, so some partners may not want to convert their partnership interests to UPREIT stock. In the meantime, because the value of the UPREIT stock is based upon the real estate held by the umbrella partnership and because the limited partners share in distributions from the umbrella partnership, the limited partnership interests are economically equivalent to the UPREIT stock.²²⁷ Consequently, some limited partners may retain their umbrella partnership interests indefinitely, and interests held by individuals at the time of their deaths would get a basis step up.²²⁸ Following the step up, the estate or heirs could convert the interests into UPREIT stock recognizing little or no taxable gain.

The UPREIT structure is another example of how the REIT structures have evolved to accommodate arrangements that were not contemplated at the time Congress created the REIT regime. The UPREIT structure also provides an opportunity for some property owners to obtain the benefits of REIT status by contributing their property to an umbrella partnership. This provides such property owners opportunities that are generally only available to wealthier investors, so perhaps UREITs reflect

222. See Rubin, Macintosh & Forrest, *supra* note 207, at 19–20; Phillip S. Scherrer, *The UPREIT: Solving the Tax Problem of Owners of Depreciated Property*, 25 REAL EST. REV. 24, 25 (1996).

223. See Rubin, Macintosh & Forrest, *supra* note 207, at 20.

224. See *id.*

225. Ponda Interview, *supra* note 219.

226. See Rubin, Macintosh & Forrest, *supra* note 207, at 21.

227. See Terence Floyd Cuff, *Investing in an UPREIT—How the Ordinary Partnership Provisions Get Even More Complicated*, 102 J. TAX'N 42, 43 (2005); John J. Grant, *Tax Planning for Umbrella Partnership REITs*, 21 J. REAL EST. TAX'N 195, 218 (1994), Singer, *supra* note 27, at 335.

228. See I.R.C. § 1014(a)(1) (2012).

the original purposes of REIT taxation by allowing smaller investors to gain the opportunities normally available to larger investors.²²⁹

4. *Pension Look-Through Rule (1993).* The REIT classification requirements generally require REITs to have at least 100 shareholders and to not be closely held.²³⁰ A REIT is closely held for this purpose if, at any time during the last half of its taxable year, more than 50% in value of its stock is owned directly or indirectly by five or fewer individuals.²³¹ The general rule considers certain tax-exempt entities, including qualified pension plans, to be individuals for purposes of this rule.²³² Consequently, under the general rule, five or fewer qualified pension plans could not hold more than 50% in value of a REIT. That rule limited the amount of capital that institutional investors brought to the real estate market. In his 1992 State of the Union Address, President George Bush said that he planned to “make it easier for pension plans to purchase real estate.”²³³ Congress also took an interest in providing greater opportunities for pension funds to invest in REITs.²³⁴ Prior to 1993, the five-or-fewer rule applied to U.S. pension plans but ironically did not restrict foreign pension plans from investing in REITs because a look-through rule applied to them,²³⁵ so Congress had to change the law to treat U.S. and foreign pension plans similarly.²³⁶ In 1993 Congress passed legislation that minimized the effect of the five-or-fewer requirement by adopting a pension look-through rule for qualified pension plans.²³⁷ The pension look-through counts beneficiaries of

229. See *supra* text accompanying note 67.

230. See § 856(a)(5), (6); § 856(h); see also *supra* text accompanying note 92.

231. See § 856(h)(1) (providing that § 542(a)(2), with some modifications, applies for purposes of determining whether a REIT is closely held); § 542(a)(2); see also *supra* text accompanying notes 93–94.

232. See § 542(a)(2).

233. See President George H.W. Bush, Address Before a Joint Session of the Congress on the State of the Union (Jan. 28, 1992) (transcript available at <http://www.presidency.ucsb.edu/ws/index.php?pid=20544>) (last visited Sept. 18, 2015).

234. See, e.g., 139 CONG. REC. 19,356 (1993) (statement of Rep. Jim Moran); David H. Downs, *The Value of Targeting Institutional Investors: Evidence from the Five-or-Fewer Rule Change*, 26 REAL EST. ECON. 613, 614–16 (1998) (discussing the events leading up to the enactment of the pension-look-through rule).

235. See § 542(a)(2) (treating only organizations within §§ 401(a), 501(c)(17), and 509(a), which do not include foreign pension plans, as individuals for purposes of the five-or-fewer rule).

236. See 139 CONG. REC. 19,356 (1993) (statement of Rep. Jim Moran).

237. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 13149, § 856(h)(3)(A),(E), 107 Stat. 312, 445–46 (codified at I.R.C. § 856(h)(3)(A), (E) (Supp. V 1994)).

qualified pension plans (and the plan itself) to determine whether the REIT is closely held.²³⁸ Thus, if a qualified plan owns 75% of a REIT's stock and it has 500 beneficiaries, the look-through rule would treat the beneficiaries as owning the REIT's stock in proportion to their actuarial interests in the qualified plan.²³⁹ The plan's 75% ownership would thus be spread over all 500 beneficiaries, and the plan would not be treated as owning 75% of the REIT. Assuming no five of the 500 beneficiaries (or direct shareholders in the REIT) have actuarial interests in the qualified plan (or directly in the REIT) that equate to more than 50% ownership of the REIT, the REIT would not be deemed to be closely held by virtue of the plan's 75% ownership interest. The pension look-through rule therefore helps REITs avoid disqualification if a few pension plans hold significant amounts of a REIT's stock. Nonetheless, pension plans have to avoid other potential pitfalls to ensure that they are not taxed on REIT dividends.

Even if a REIT can avoid being closely held, if the REIT comes within the definition of pension-held REIT, a qualified plan that holds stock in the REIT could be subject to tax on any unrelated business taxable income (UBTI). The qualified plan will have UBTI in proportion to its share of income that would be UBTI to the REIT, if the REIT were a tax-exempt entity.²⁴⁰ A REIT is a pension-held REIT only if the REIT would not have satisfied the closely-held requirement but for the look-through rule and a qualified trust owns at least 25% of the value of the REIT or one or more qualified trusts (each of which owns at least 10% of the REIT) in the aggregate own more than 50% of the value of the REIT.²⁴¹

Rental from real estate and gains from the sale of real estate held for use in a trade or business or for investment generally do not come within the definition of UBTI,²⁴² but rent or gain that is

238. See sec. 13149, § 856(h)(3)(A)(i), 107 Stat. at 445 (codified at I.R.C. § 856(h)(3)(A)(i) (Supp.V 1994)).

239. See § 856(h)(3)(A)(i).

240. See § 856(h)(3)(C) (applying this rule to pension-held REITs). Indeed, pension funds use REITs that are not pension-held REITs to block income that would otherwise be UBTI to the pension. See Willard B. Taylor, "Blockers," "Stoppers," and the Entity Classification Rules, 64 TAX LAW. 1, 6-7 (2010).

241. See § 856(h)(3)(D).

242. See § 512(a) (defining UBTI, and allowing for modifications defined in § 512(b)); § 512(b)(3) (excluding all rents from real property from UBTI); § 512(b)(5) (excluding most gains from the sale of property from UBTI); see also Bradley T. Borden & Katherine E. David, *Sales of Church Real Property to Parishioners*, TAX'N EXEMPTS, July-Aug. 2012, at 4-5 (discussing UBTI and the exemption for sales of property).

debt-financed income is UBTI.²⁴³ Thus, even if a pension-held REIT limits its activities to owning and leasing real estate and only provides customary tenants' services, the pension trust that holds shares of a pension-held REIT would have no UBTI only if the REIT had no debt-financed income. The consequence of a qualified plan owning an interest in a pension-held REIT could, therefore, be significant. Even though REITs generally should have income from real estate rent and sales of property held for investment or for use in a rental business, which would not be UBTI to the REIT,²⁴⁴ REITs also generally use debt to purchase or construct real property and therefore have debt-financed income.²⁴⁵ Pension trusts can ensure that they do not have UBTI from a REIT by either ensuring that none of the REIT's income comes within the definition of UBTI or by ensuring that the REIT is not a pension-held REIT. Because of debt financing, the former alternative is not feasible, so pension trusts invest in non-pension-held REITs.

The rules governing qualified trusts' ownership of REIT stock appear to leave a loophole for state-sponsored pension funds. State-sponsored pension funds often will not come within the definition of qualified pension trust for purposes of the look-through rules because they will not satisfy all of the qualified trust requirements that private pension trusts satisfy.²⁴⁶ Nonetheless, such plans are not individuals, so they are not an entity treated as a trust for the REIT definition of "closely held." Therefore, they would not count toward the five-individual rule or the pension-held rules and should be able to own a large interest in a REIT without triggering the closely-held prohibition or the pension-held rules.²⁴⁷

243. See § 514. *But see* § 514(c)(9) (providing an exception to this rule for qualified pension trusts and other qualified organizations).

244. See § 856(c)(2).

245. See generally Zhilan Feng, Chinmoy Ghosh & C.F. Sirmans, *On the Capital Structure of Real Estate Investment Trusts (REITs)*, 34 J. REAL EST. FIN. & ECON. 81, 90 (2007) (reporting that on average REITs maintain a debt ratio of above 50% while non-REIT firms have maintained a ratio below 50%, and a REIT's debt ratio grows and stabilizes around 65% ten years after an IPO).

246. See § 401(a) (defining qualified trust); § 856(h)(3)(E) (requiring a pension trust to be a qualified trust to qualify for the look-through rule). State pension plans are tax exempt, even if they do not come within the definition of qualified trust. See § 457(a) (providing that amounts deferred through or income earned in an eligible deferred compensation plan are subject to tax when paid to a participant); § 457(b) (defining eligible deferred compensation plan as one established and maintained by an eligible employer that satisfies several other requirements); § 457(e)(1) (defining eligible employer to include states and their political subdivisions and agencies).

247. See Bradley T. Borden, *Real Estate Transactions by Tax-Exempt Entities*, 591-3d Tax Mgmt. Portfolio (BNA) A-9 (2015).

The pension-look-through rule opened the door for pensions to own considerable amounts of REIT stock. Surely in 1960, Congress did not foresee the rise of private pension funds and their future interest in owning REIT equity.²⁴⁸ Pension funds owning REIT stock does not appear to be inconsistent with the original purpose of the REIT regime, which was to make real estate portfolio investment available to a broad group of individual investors. Because pension funds own assets on behalf of employees, their ownership of REIT equity provides indirect ownership of real estate to a significant segment of the population.²⁴⁹ Nonetheless, the significant rise in REIT market capitalization following the enactment of the pension-look-through rules suggests that the change has brought more capital to real estate markets,²⁵⁰ which was one purpose REIT proponents originally espoused in favor of the REIT regime.²⁵¹

5. *More Lenient Distribution Requirement (1999)*. Prior to 2000, tax law required REITs to distribute at least 95% of their taxable income to avoid entity-level tax on all taxable income.²⁵² Legislation in 1999 reduced the requirement to 90%, so now REITs must distribute at least 90% of their taxable income as dividends each year.²⁵³ The history of this rule appears to trace back to the RIC rules.²⁵⁴ At the time Congress enacted the REIT rules, open-end and closed-end funds competed for investor contributions, but most funds were closed-end funds.²⁵⁵ Open-end funds buy back shares from shareholders upon the shareholder request, but holders of interests in closed-end funds generally must sell their interests in the public market to cash out of their investments.²⁵⁶ Prior to the RIC legislation, closed-end funds were

248. Nonetheless, shortly after Congress enacted the 1960 legislation, the IRS sanctioned REIT stock ownership by pension trusts. See Rev. Rul. 66-106, 1966-1 C.B. 151 (ruling that REIT dividends paid to an exempt employee's pension trust do not constitute unrelated taxable income).

249. *Economic Impact of REITs: REITs by the Numbers*, REIT, <https://www.reit.com/investing/reit-basics/reits-numbers> (last visited Sept. 18, 2015) (claiming that more than 70 million Americans invest in REITs through their retirement plans).

250. See *infra* Appendix A.

251. See *supra* text accompanying note 68.

252. See § 857(a)(1)(A) (Supp. IV 1999).

253. See § 857(a)(1)(A); Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, sec. 556(a), § 857(a)(1)(A), 113 Stat. 1860, 1949 (codified at I.R.C. § 857(a)(1)(A) (Supp. IV 1999)).

254. See H.R. Rep. No. 86-2020, at 3 (1960).

255. See Brunson, *supra* note 41 (manuscript at 11); Morley, *supra* note 42, at 348-55.

256. See Brunson, *supra* note 41 (manuscript at 11); Morley, *supra* note 42, at 348.

much more popular among investors than open-end funds.²⁵⁷ Commentators speculate that managers of open-end funds lobbied Congress for the RIC distribution requirement to put open-end and closed-end funds on similar grounds.²⁵⁸ Thus, the RIC distribution requirement is a product “of self-interested lobbying and historical accident, rather than functional necessity.”²⁵⁹

The RIC distribution requirement carried over to the REIT regime as part of the effort to assure that real estate trusts would be treated the same as RICs.²⁶⁰ Nonetheless, commentators see in the REIT distribution requirement a device that “prevent[s] REITs from becoming unconstrained tax deferral devices.”²⁶¹ The REIT distribution requirement can result in REIT taxable income being subject to a higher effective tax rate than corporate taxable income.²⁶² Undoubtedly the distribution rules prevent REITs from retaining earnings in excess of taxable income, but REIT distributions average more than 120% of REIT taxable income.²⁶³ Several commentators have tried to explain why REITs pay dividends in excess of taxable income.²⁶⁴ They suggest that REITs might use high dividend payouts to control agency costs,²⁶⁵ to

257. See Brunson, *supra* note 41 (manuscript at 11); Morley, *supra* note 42, at 349–50.

258. See Brunson, *supra* note 41 (manuscript at 11); Morley, *supra* note 42, at 346, 391.

259. See Morley, *supra* note 42, at 346.

260. See *supra* note 86 (illustrating the dividend-paid deduction for qualifying REITs).

261. See Austan Goolsbee & Edward Maydew, *Taxes and Organizational Form: The Case of REIT Spin-offs*, 55 NAT'L TAX J. 441, 444 (2002).

262. See Bradley T. Borden, *Counterintuitive Tax Revenue Effect of REIT Spinoffs*, 146 TAX NOTES 381, 382–84 (2015) [hereinafter Borden, *Counterintuitive Tax Revenue Effect*] (showing that if individuals hold all of the stock of a corporation and a REIT and the corporation distributes only 25% of its taxable income, the effective tax rate on the REIT taxable income can be greater than the effective tax rate on the corporate taxable income).

263. See Walter I. Boudry, *An Examination of REIT Dividend Payout Policy*, 39 REAL EST. ECON. 601, 612–14 (2011) (estimating discretionary dividends to be 17.9% of total dividends, making the taxable portion 82.1% and the total dividend 121.8% (100 ÷ 82.1) of taxable income); REIT.com, *Historical Tax Treatment of REIT Common Share Dividends*, YEAR-END TAX REPORTING DATA, <https://www.reit.com/sites/default/files/IndustryData/HistoricalDividendAllocationSummary.pdf> (showing the following dividend composition of publicly-traded REITs: 69% ordinary income, 17% return of capital, 14% long-term capital gain). Distributions in excess of taxable income suggest that REIT cash flow exceeds REIT taxable income. This is expected because depreciation deductions reduce taxable income but do not affect cash flow. See I.R.C. §§ 167, 168 (2012) (granting the depreciation deduction independent of cash payments).

264. See CHAN, ERICKSON & WANG, *supra* note 13, at 134–38 (listing five reasons gleaned from scholarly work and the popular press).

265. See Ko Wang, John Erickson & George W. Gau, *Dividend Policies and Dividend Announcement Effects for Real Estate Investment Trusts*, 21 REAL EST. ECON. 185, 197, 199–200 (1993).

reduce asymmetric information,²⁶⁶ to attract investors,²⁶⁷ to signal private information,²⁶⁸ and to signal future cash flow expectations.²⁶⁹ Higher cash flow also affects the dividend policy.²⁷⁰ Empirical analysis suggests that REITs pay higher dividends to adjust toward a target level of total dividends and provide dividend smoothing, which appears to provide the best explanation of REIT dividends in excess of taxable income.²⁷¹ Finally, because depreciation deductions reduce taxable income but not cash flow,²⁷² the total dividend in excess of the taxable portion could be attributed in part to that distinction.

The distribution requirement also serves an important tax accounting function. Perhaps the greatest challenge that partnership tax faces is properly governing allocations of tax items to partners.²⁷³ Even though REIT taxation is often referred to as a flow-through or conduit tax regime, it does not incorporate complex allocation rules comparable to those found in the partnership tax rules.²⁷⁴ Instead, the REIT regime merely requires

266. See Cynthia G. McDonald, Terry D. Nixon & V. Carlos Slawson, Jr., *The Changing Asymmetric Information Component of REIT Spreads: A Study of Anticipated Announcements*, 20 J. REAL EST. FIN. & ECON. 195, 201–04 (2000).

267. See CHAN, ERICKSON & WANG, *supra* note 13, at 137–38.

268. See Wang, Erickson & Gau, *supra* note 265, at 193–194, 198–99.

269. See Michael Bradley, Dennis R. Capozza & Paul J. Sequin, *Dividend Policy and Cash-Flow Uncertainty*, 26 REAL EST. ECON. 555, 571–77 (1998) (considering both asymmetric information and signaling to conclude that reducing dividends signals future cash-flow volatility); William Hardin, III & Matthew D. Hill, *REIT Dividend Determinants: Excess Dividends and Capital Markets*, 36 REAL EST. ECON. 349, 363–64 (2008) (concluding that REITs pay excess dividends based on actual and expected operating cash flows and are aware that a reduced dividend would send a negative signal).

270. See Boudry, *supra* note 263, at 621.

271. See Boudry, *supra* note 263, at 625–26.

272. See I.R.C. §§ 167–168 (2012).

273. Several articles discuss challenges that allocations rules face. See, e.g., Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. CIN. L. REV. 1077, 1098 (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); Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381, 1433–35 (2009); Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Transactions*, 59 S.C. L. REV. 297, 335–38 (2008); Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1074–79 (2006); Stephen Utz, *Allocation and Reallocation in Accordance with the Partners' Interests in the Partnership*, 56 TAX LAW. 357, 364–66 (2003); Walter D. Schwidetzky, *The Partnership Allocation Rules of Section 704(b): To Be or Not to Be*, 17 VA. TAX REV. 707, 708, 740 (1998); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 9–15 (1990); Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 545, 613 (1986).

274. See I.R.C. § 704(b); Treas. Reg. § 1.704-1 to -3 (as amended in 2013) (presenting rules governing partnership allocations of tax items); *supra* note 273 (citing articles that discuss the complexity of the allocation rules).

the shareholders to whom distributions are made to report the distributions as dividends, to the extent the distributions represent taxable income of the REIT,²⁷⁵ and allows REIT shareholders to recognize relevant portions of the dividends as capital gain that flows through from the REIT.²⁷⁶ REITs may have different classes of stock,²⁷⁷ so a distribution might only cover the REIT's obligations to holders of preferred stock, and only those shareholders would recognize dividend income on the distribution. The holders of other classes of REIT stock who do not receive distributions would not recognize any income. Thus, REIT taxation effectively allocates all of the income from any given tax year only to the shareholders to whom the REIT makes a distribution. Those shareholders appear to obtain the economic benefit of the distribution and the taxable income associated with it,²⁷⁸ so the law appears to properly allocate the REIT's tax items to shareholders. The requirement to distribute taxable income thus solves problems that exist in the partnership tax regime, which does not require distributions and struggles to properly govern the allocation of tax items.²⁷⁹

6. *Taxable REIT Subsidiaries and Further Expansion of Tenant Services (1999)*. As discussed above, the REIT industry in the past successfully argued that REITs are at a competitive disadvantage compared to other real estate owners because the REIT regime requires REIT revenues to be passive and restricts the types of services that a REIT can perform.²⁸⁰ Although the 1986 changes allowed REITs to directly provide customary tenant

275. See I.R.C. § 61(a)(7) (including dividends in gross income); § 301(c) (defining dividend); Treas. Reg. § 1.857-6 (as amended in 1986) (requiring REIT shareholders to recognize income in the year they receive a REIT dividend and describing how to compute the amount of income). Distributions are also dividend income if they are part of a purging dividend from the REIT. See I.R.C. § 857(a)(2)(B); Treas. Reg. § 1.337(d)-7(b)(4) (as amended in 2014) (illustrating section 1374 treatment on REIT election).

276. See 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).

277. See Michael E. Shaff, *The Services Trend of Friendly REIT Rulings Continues*, 4 COLUM. J. TAX L. TAX MATTERS 17, 19 (2013) (noting that a REIT had three different classes of stock).

278. See Treas. Reg. § 1.704-1(b)(2)(ii)(a) (as amended in 2013) (requiring that the partner to whom a tax item is allocated must also bear the economic burden and enjoy the tax benefit associated with the tax item). Commentators question, however, whether the rules adequately ensure that partnership economic results follow tax-item allocations. See *supra* note 273.

279. See *supra* note 273.

280. See *supra* text accompanying notes 178–82.

services,²⁸¹ the rules still significantly restricted the services REITs could provide with respect to their real estate. In 1999, Congress expanded the exception to impermissible tenant service income to allow REITs to provide noncustomary tenant services through a taxable REIT subsidiary.²⁸² After that change, REITs may now indirectly provide noncustomary tenant services to tenants through a subsidiary, subject to certain organizational, ownerships, funding, and accounting rules.²⁸³ The organizational rules provide that a taxable REIT subsidiary must be a corporation that is not a REIT, in which the REIT holds some stock (without a minimum or maximum ownership requirement, so the rules allow a REIT to be the sole owner) and that makes an election, along with the REIT, to be a taxable REIT subsidiary.²⁸⁴ The definition also includes any corporation more than 35% of the voting or value of which is owned by a taxable REIT subsidiary.²⁸⁵ A corporation that directly or indirectly operates or manages a lodging or health care facility (or provides the brand name for such a facility), does not come within the definition of taxable REIT subsidiary.²⁸⁶ Finally, the value of all of the taxable REIT subsidiary stock held by a REIT cannot exceed 25% of the value of the REIT's total assets.²⁸⁷

The accounting and funding rules are somewhat complex, but they help ensure that any amount paid by tenants that are for services provided by the taxable REIT subsidiary are subject to a full entity-level tax. For example, a REIT's standard lease agreement may provide that tenants will make payments only to the REIT, even though the payments include

281. See *supra* text accompanying notes 186–91.

282. See Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, § 542(a), 113 Stat. 1860, 1941 (codified at I.R.C. § 856(d)(7)(C)(i) (Supp. IV 1999)). As part of the 1986 amendments, Congress allowed REITs to hold property through wholly-owned qualified REIT subsidiaries, which tax law disregarded. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 662(a), 100 Stat. 2085, 2300–02 (codified at I.R.C. § 856(i) (Supp. IV 1987)). The 1999 amendment specifically provided that a qualified REIT subsidiary could not be a taxable REIT subsidiary. See § 543(b), 113 Stat. at 1944 (codified at I.R.C. § 856(i)(2) (Supp. IV 1999)).

283. See, e.g., Rev. Rul. 2002-38, 2002-2 C.B. 4–6 (ruling favorably for a taxable REIT subsidiary that provided housekeeping services); David L. Brandon & Mario J. Deluca, *Opportunity Knocks for Taxable REIT Subsidiaries*, 92 J. TAX'N 141, 141–42 (2000) (“Although TRSs are taxed as ordinary C corporations, they generally may provide any type of noncustomary tenant services, without using an independent contractor”); Decker, Kaplan & Ponda, *supra* note 28, at 421.

284. See I.R.C. § 856(l)(1) (2012).

285. See § 856(l)(2).

286. See § 856(l)(3). See Decker, Ponda & Stein, *supra* note 28, at 1234–35.

287. See § 856(c)(4)(B)(ii).

non-separately-stated amounts for noncustomary tenant services (such as housekeeping) provided by a taxable REIT subsidiary to the tenants.²⁸⁸ The amounts the REIT receives that are attributable to the taxable REIT subsidiary's services do not come within the definition of impermissible tenant services,²⁸⁹ but if the REIT does not pay those amounts to the taxable REIT subsidiary as compensation, then the REIT must pay a 100% tax on the amounts by which the taxable REIT subsidiary is undercompensated.²⁹⁰ The 100% tax does not apply, however, if the amount attributable to services to a property is less than 1% of the total amount the REIT receives from the tenant with respect to the property.²⁹¹ The 100% tax also does not apply if the amount the REIT pays to the taxable REIT subsidiary is at least 150% of the costs the taxable REIT subsidiary incurs to provide the services.²⁹² The REIT can, of course, avoid the 100% tax by paying sufficient compensation to the REIT subsidiary for the services it provides. Any amounts paid by the REIT to the taxable REIT subsidiary for services are of course subject to the taxable REIT subsidiary's corporate tax rate.²⁹³ Consequently, REITs would prefer to pay as little as possible to the taxable REIT subsidiary but still avoid the 100% tax. Of the two alternatives, paying amounts to the subsidiary should provide the better tax result because the subsidiary will pay tax at the corporate rate, not the 100% rate the REIT would pay.

In limited circumstances, a taxable REIT subsidiary may lease property from the REIT, and the amounts paid by the taxable REIT subsidiary will come within the definition of rents from real property, regardless of the percentage ownership the REIT has in the subsidiary.²⁹⁴ For the payments to qualify as rents from real property, however, the REIT cannot rent more than 10% of the

288. See Rev. Rul. 2002-38, 2002-2 C.B. 4.

289. See § 856(d)(7)(C)(i).

290. See § 857(b)(7); Rev. Rul. 2002-38, 2002-2 C.B. 4. The amounts representing payments for services that the REIT does not pay to the taxable REIT subsidiary are called "redetermined rents." See I.R.C. § 857(b)(7)(B)(i). The amount of redetermined rents relies upon (and replaces) I.R.C. § 482. See *id.*; § 857(b)(7)(E).

291. See § 857(b)(7)(B)(ii).

292. See § 857(b)(7)(B)(v). Even if the REIT satisfies this requirement, the IRS may allocate a portion of the rent to the taxable REIT subsidiary, and the reallocated portion would be subject to the taxable REIT subsidiary's corporate tax rate. See Rev. Rul. 2002-38, 2002-2 C.B. 4.

293. See § 11.

294. See § 856(d)(8). This is an exception to the general rule that excludes from the definition of rents from real property any amount that a REIT receives from a person in which the REIT has at least a 10% ownership interest. See § 856(d)(2)(B).

leased space of the property to a taxable REIT subsidiary or other person under the REIT's control.²⁹⁵ To come within this rule, the amount the taxable REIT subsidiary pays in rent must, however, be substantially comparable to rent paid by other tenants for use of the property.²⁹⁶ Recall that a taxable REIT subsidiary cannot manage or operate the REIT's lodging or health care facilities.²⁹⁷ Nonetheless, the leasing rules allow a taxable REIT subsidiary to lease such facilities from the REIT (without restriction on the portion of the property the subsidiary may lease), if an eligible independent contractor manages or operates the facilities.²⁹⁸

By allowing taxable REIT subsidiaries to operate and manage property and provide other noncustomary tenant services to REIT tenants, Congress effectively eliminated any remaining barriers that otherwise prohibited REITs from actively managing property and providing cutting-edge services at properties. With these taxable REIT subsidiary rules, a REIT can now form a wholly owned corporate subsidiary and manage the property and provide noncustomary tenant services through that subsidiary. Because the REIT controls the taxable REIT subsidiary, the subsidiary's actions occur at the REIT's direction, so the REIT essentially provides the services. This rule clearly extends the REIT regime beyond that originally envisioned by Congress, but the entity-level tax paid on services provided by the taxable REIT subsidiary ensures that the rule does not erode the corporate tax base with respect to noncustomary tenant services. The expansion also moves REIT operations closer to partnership operations, providing REIT investors treatment that more closely reflects treatment afforded direct investors in real estate.

The REIT industry cheers these changes because REITs can reduce agency costs by controlling the provision of tenant services through taxable REIT subsidiaries, instead of hiring independent contractors.²⁹⁹ Tenants also prefer receiving services from the

295. See § 856(d)(8)(A)(i). A person is under the REIT's control for this purpose if the REIT owns (directly or by attribution) at least 10% of the vote or value, in the case of a corporation, or at least 10% of the assets or net profits of a noncorporate entity. See § 856(d)(2)(B).

296. See § 856(d)(8)(A)(ii).

297. See *supra* text accompanying note 286.

298. See § 856(d)(8)(B) (allowing the taxable REIT subsidiary to hold licenses or permits enabling the operation or management of the property and to employ the workers of such facilities or property located outside the United States, if the eligible independent contractor is responsible for the daily supervision and direction of such individuals); see also § 856(d)(9) (defining eligible independent contractor).

299. See *supra* note 182.

REIT because they are familiar with REIT management.³⁰⁰ Finally, the taxable REIT subsidiary rules have fewer foot faults and gotcha provisions than prior rules.

7. *REIT Spinoffs (2001)*. The review of the history of REIT taxation to this point shows that Congress has significantly relaxed the rules governing services that REITs can provide tenants. In addition to allowing REITs to take greater control of their assets through the types of services they can provide, the changes opened the door for the IRS to later rule that REITs can satisfy the active trade or business requirement of the tax-free spinoff rules.³⁰¹ A tax-free REIT spinoff requires that both the operating corporation and the REIT be engaged in a historically active trade or business immediately following the spinoff.³⁰² Prior to the 1986 expansion of the types of services that a REIT can perform, the IRS had ruled that a REIT cannot satisfy the tax-free spinoff active trade or business requirement.³⁰³ After Congress enacted the 1986 changes, a REIT could perform “activities that can constitute active and substantial management and operational functions with respect to rental activity.”³⁰⁴ Consequently, a REIT now can satisfy the tax-free spinoff active trade or business requirement, so a REIT spinoff can be tax-free.³⁰⁵

8. *REIT Definition of Real Estate (1969–Present)*. The primary assets of REITs must be primarily real estate assets,³⁰⁶ which includes real property.³⁰⁷ Some commentators claim that the application of REIT taxation is expanding as the IRS issues rulings granting REIT classification to entities that hold assets that appear to stretch the boundaries of the definition of “real property.”³⁰⁸ For example, over the past few decades the IRS has

300. Ponda Interview, *supra* note 214.

301. See Staffaroni, *supra* note 27, at 544–45 (noting that the Service changed its view in 2001).

302. See § 355(b)(1).

303. See Rev. Rul. 73-236, 1973-1 C.B. 183–84.

304. See Rev. Rul. 2001-29, 2001-1 C.B. 1348, 1349.

305. See *id.*

306. See § 856(c)(4)(A) (requiring that at least 75% of a REIT's assets be real estate assets, cash, and government securities).

307. See § 856(c)(5)(B) (defining real estate assets to include real property).

308. See Micah W. Bloomfield & Neal D. Richards, *New Rulings Present Opportunities, but Not Carte Blanche*, 4 COLUM. J. TAX L. TAX MATTERS 1 (2013); Boos, *supra* note 28, at 1292 (“These examples, combined with a potentially liberal interpretation of what constitutes real property, have made REITs a more attractive entity structure for avoiding taxes.”); John Patrick Dowdall, *Defining Real Property and Its Consequences*, 4 COLUM. J. TAX L. TAX MATTERS 5, 5 (2013); Todd D. Keator, *REITs and the Expanding Universe of*

ruled that the following types of property come within the definition of real property: railroad property (including tracks, roadbeds, buildings, bridges, and tunnels);³⁰⁹ mobile home units;³¹⁰ a total energy system that produces electricity, steam, hot water, and refrigeration for commercial and industrial buildings;³¹¹ components of a microwave transmission system, including buildings, transmitting and receiving towers, and a chain link fence;³¹² central refrigeration systems of cold storage warehouses;³¹³ an electricity transmission system;³¹⁴ a gas pipeline system;³¹⁵ a product delivery system consisting of hoses, pipes, manifolds, valves, an underground scale, loading racks, a system of insulated heat traced pipes, storage tanks, boilers, blending devices, interests or rights to occupy the land, and various driveways, docks, rail spurs, dikes, containment areas, and security fencing;³¹⁶ wireless and broadcast communication towers;³¹⁷ and billboards.³¹⁸ Figure 6 contrasts the traditional notion of real property at the time Congress created the REIT tax regime with today's understanding of what constitutes real property.³¹⁹

"Rents from Real Property," 4 COLUM. J. TAX L. TAX MATTERS 12, 12 (2013) (noting that the IRS has recently issued several private letter rulings that expand the definition of real property in the context of infrastructure assets); Steven F. Mount, *New Wine in Old Bottles: Has the Definition of "Real Estate Assets" Been Expanded for Real Estate Investment Trusts?*, 54 TAX MGMT. MEMO. 383, 383 (2013); Michael E. Shaff, *The Services Trend of Friendly REIT Rulings Continues*, 4 COLUM. J. TAX L. TAX MATTERS 17, 20 (2013) ("The Service continues its long-standing practice of issuing favorable rulings, private as well as published, on REIT qualification issues, including assets constituting real property . . .").

309. See Rev. Rul. 69-94, 1969-1 C.B. 189.

310. See Rev. Rul. 71-220, 1971-1 C.B. 210.

311. See Rev. Rul. 73-425, 1973-2 C.B. 222-23.

312. See Rev. Rul. 75-424, 1975-2 C.B. 270.

313. See I.R.S. Priv. Ltr. Rul. 1999-04-019 (Oct. 30, 1998).

314. See I.R.S. Priv. Ltr. Rul. 2007-25-025 (Mar. 22, 2007).

315. See I.R.S. Priv. Ltr. Rul. 2009-37-006 (Mar. 3, 2009).

316. See I.R.S. Priv. Ltr. Rul. 2010-05-018 (Oct. 6, 2009).

317. See I.R.S. Priv. Ltr. Rul. 2011-29-007 (Apr. 6, 2011).

318. See I.R.S. Priv. Ltr. Rul. 2011-43-011 (July 19, 2011).

319. What constitutes traditional REIT assets is a point of controversy. For instance, in 1969, the IRS ruled that railroad property comes within the REIT definition of real property. See Rev. Rul. 69-94, 1969-1 C.B. 189. Because that ruling followed shortly after the 1960 REIT legislation, some people view railroad property as a traditional REIT asset. Consequently, any attempt to classify real property as traditional and non-traditional REIT assets will be met with conflicting views. The difficulty in identifying a definitive list of traditional and non-traditional REIT assets lends support to the view that the REIT definition of real property is not expanding.

**Figure 6:
Evolution of REIT Asset Groups**

Traditional REIT Assets (1960)	REIT Assets (Today)	
<ul style="list-style-type: none"> • Industrial • Multi-Family Housing • Office • Retail 	<ul style="list-style-type: none"> • Air Rights • Billboards • Casinos • Cell Towers • Data Centers • Infrastructure Assets • Mortgages • Mortgage-Backed Securities • Oil & Gas Pipelines 	<ul style="list-style-type: none"> • Prisons • Rail Road Properties • Storage Facilities • Telecommunication Assets • Timber Assets • More . . .

Other commentators, the Treasury, and the IRS do not perceive this evolution as an expansion of the definition of real property.³²⁰ More recently, the Treasury Department published proposed regulations that would codify a definition of real property that is consistent with prior IRS rulings,³²¹ so all indications are that the use of REITs will continue to grow.³²² The proposed regulations define real property generally as land and improvements to the land.³²³ Land includes “water and air space superjacent to land and natural products and deposits that are

320. See Nugent, *REIT Spinoffs*, *supra* note 28, at 1519–23; Ameek Ashok Ponda, *Practitioner Suggests Modifications to Proposed REIT Regs*, 2014 TAX NOTES TODAY 177-22 (Aug. 11, 2014) (applauding the publication of the proposed regulations and recommending some changes to them).

321. See Prop. Treas. Reg. § 1.856-10, 79 Fed. Reg. 27508, 27511 (May 10, 2014). The regulations fill an important gap in the REIT rules. See, e.g., Taylor, *Closing the Gap*, *supra* note 28, at 597 (praising the regulations for addressing the definition of real property and recommending that the IRS issue more guidance related to other REIT issues, such as the definition of rent from real property and determining the value of a REIT's assets).

322. See Steven F. Mount, *Definition of “Real Property” for Real Estate Investment Trusts—Prop. Reg. § 1.856-10 “Codifies” Current Law*, 55 TAX. MGMT. MEMO. 371, 378 (2014) (noting that the definition of real property has expanded to include certain intangible assets); see also Taylor, *Closing the Gap*, *supra* note 28, at 598 (noting that the REITs' rapid growth reflects the IRS's willingness to expand on what constitutes real property and what constitutes rent from real property).

323. See Prop. Treas. Reg. § 1.856-10(b).

unsevered from the land.”³²⁴ Improvements to land include “inherently permanent structures and their structural components,”³²⁵ which must serve a passive function, such as containing, supporting, sheltering, covering, or protecting.³²⁶ The proposed definition includes property that the IRS had previously ruled comes within the definition of real estate assets, so such property would continue to qualify as real property under the proposed regulations. The proposed regulations also include intangible property, such as the goodwill of a REIT, in the definition of real property.³²⁷ The inclusion of goodwill within the definition provides guidance needed by REITs that merge or otherwise acquire property and must account for part of the acquired assets as goodwill.³²⁸ Thus, the proposed regulations would appear to provide the basis for continuing to interpret the definition of real property to account for changes in the economy. As a result, the application of the REIT regime will most likely continue to expand.

The interpretation of the definition of real property is an example of how REIT developments have followed President Eisenhower’s prediction that REITs would include not just the traditional type of real property held by real estate trusts in 1960 when Congress created REITs, but would grow to unanticipated uses of the REIT tax regime.³²⁹ One could argue, however that the expansion of the REIT regime is consistent with the stated purpose of making investment in a diverse portfolio of real estate available to more investors. REITs now offer the average investor the opportunity to invest in REITs that hold only billboards, railroad property, prisons, or other nontraditional types of real estate.³³⁰ That opportunity would not be available if the IRS had restricted the definition of real property. Furthermore, President Eisenhower appeared to have assuaged his own concerns about the possible expansion of the REIT regime by signing the REIT legislation into law shortly after expressing his concern.³³¹

324. See Prop. Treas. Reg. § 1.856-10(c).

325. See Prop. Treas. Reg. § 1.856-10(d)(1).

326. See Prop. Treas. Reg. § 1.856-10(d)(2)(iii)(A).

327. See Prop. Treas. Reg. § 1.856-10(f).

328. See I.R.S. Priv. Ltr. Rul. 2008-13-009 (Dec. 13, 2007) (ruling that to the extent the value of real estate intangibles (determined as part of a REIT property acquisition) is inextricably linked to the underlying real estate, the intangibles will be treated as real estate assets under the REIT asset test).

329. See *supra* text accompanying note 78.

330. See Taylor, *Closing the Gap*, *supra* note 28, at 598.

331. See *supra* text accompanying notes 74–79.

The interpretation of the definition of real property may encroach on other aspects of the limits of the REIT regime. As assets that have traditionally been an integral part of operating businesses come within the definition of real property, questions arise regarding whether the revenue from such property is from an active source. The taxable REIT subsidiary rules help illustrate this concept. A taxable REIT subsidiary may manage and operate an apartment complex that a REIT owns. The management helps facilitate the rental of the property to resident tenants. Contrast that with the type of operation that Windstream does with respect to its real estate assets. It provides telecommunication and other technology services to its customers and requires fiber and copper networks to provide those services.³³² Its assets serve a single purpose and will have a single tenant following the spinoff. The lease to the Windstream will undoubtedly require Windstream, not the REIT, to maintain the real estate assets.³³³ The single-tenant, single-purpose nature of the Windstream real estate, makes it similar to other assets, such as football stadiums that have a single tenant and a single purpose. The focus of the regulations on the physical nature of real estate suggests that the IRS and Treasury do not consider the use of the property to be a meaningful part of the REIT definition of real estate.³³⁴ Under that interpretation, the REIT definition arguably has not expanded since Congress first enacted REIT taxation.

III. WHAT'S THE MATTER WITH REITS?

The discussion to this point describes REITs, but it does not implicate REIT taxation in any wrongdoing or serious policy violation. Much of the focus in the media and the Camp Proposal is on REIT spinoffs and conversions and the so-called expansion of the definition of real estate.³³⁵ The concern is that REIT taxation erodes the corporate tax base by treating REITs and regular corporations differently.³³⁶ Embedded within the corporate-tax-base erosion concern is an inequity argument: corporate-tax-base erosion occurs because tax law treats real

332. See Windstream News Release, *Windstream to Spin Off Assets into Publicly Traded REIT*, WINDSTREAM (July 29, 2014), http://news.windstream.com/article_display.cfm?article_id=1561.

333. See *id.*

334. See *supra* text accompanying notes 309–28 (indicating the different types of properties that have come within the definition of real property).

335. See *supra* notes 1–3.

336. See *id.*

estate owned by regular corporations differently from real estate owned by REITs.³³⁷ In pursuit of benefits provided by REIT taxation, property owners expend significant resources to separate property ownership from operations, perhaps resulting in less-than-optimally-efficient ownership structures.³³⁸ The potential problems with REIT taxation from a tax-policy standpoint therefore appear to be threefold: (1) it negatively affects tax revenue, (2) it creates inequity, and (3) it fosters inefficiency. The following discussion illustrates that none of these perceived problems stand up well under careful scrutiny.

Because none of these policy concerns warrant the negative attention directed at REITs, this Article suggests that bad optics, more than bad policy, may motivate the media and Representative Camp.³³⁹ In other words, because REIT spinoffs look something like corporate inversions and take income from regular corporations, people think they are bad.³⁴⁰ Even though eliminating bad optics is not a tax policy objective, this analysis considers it as an explanation for the criticism of REIT taxation. By recognizing that bad optics are causing consternation and addressing bad optics directly, this Article should help assuage the concerns of those who are deceived by superficial appearances. In fact, the following analysis illustrates that REIT taxation generally accomplishes the stated purposes for enacting the REIT regime—it makes real estate portfolio ownership available to a larger portion of the population, it channels capital to the real estate market, and it enhances equity between RIC and real estate investors.³⁴¹

A. *Tax-Base Erosion*

Tax-base erosion is the primary complaint about REIT spinoffs and conversions with a particular focus on the corporate-tax-base erosion.³⁴² In fact, one of the Camp Proposal's

337. Inequity results when the law treats two similarly situated persons differently. See Peter Westen, *The Empty Idea of Equality*, 95 HARV. L. REV. 537, 542–43 (1982) (“[E]quity in morals means this: things that are alike should be treated alike, while things that are unlike should be treated unlike in proportion to their unalikehood.” (quoting ARISTOTLE, *ETHICA NICOMACHEA* V. 3, 1131a–31b (W.D. Ross trans., 1925))).

338. See *infra* Part III.C.1.

339. See *supra* notes 2–3.

340. See, e.g., Amy S. Elliott, *Year in Review: REIT and PTP Converters—the Other Corporate Deserters?*, 146 TAX NOTES 20 (2015) (recognizing that observers compare REIT spinoffs and conversions to corporate inversions).

341. See *supra* text accompanying notes 62–70.

342. See *supra* notes 2–3. Other commentators also focus on corporate-tax-base erosion. See, e.g., Amy S. Elliott, *Sears’ REIT Considerations Represent Base Erosion Threat*, 145 TAX NOTES 751, 751–52 (Nov. 17, 2014) (considering the announcement by

enumerated reasons for eliminating tax-free REIT spinoffs is that the "REIT rules were not intended to facilitate erosion of the corporate tax base."³⁴³ The focus on corporate-tax-base erosion as a criticism of REIT taxation is problematic for several reasons. First, the concern about eroding the corporate tax base featured prominently in President Eisenhower's 1957 veto letter.³⁴⁴ The President's stated objection did not reflect a concern of Congress—Congress had already passed the bill.³⁴⁵ The concern about REIT taxation eroding the corporate tax base therefore should not be attributed to Congress. Apparently Congress was not concerned about the effect the legislation would have on the corporate tax base, or it realized that expanding opportunities for real estate investment and channeling capital to real estate markets would outweigh the cost of corporate-tax-base erosion.

Second, within a few years after expressing concern that the REIT legislation would erode the corporate tax base, President Eisenhower signed the REIT legislation that has the same effect on the corporate tax base that the previously vetoed legislation would have had.³⁴⁶ Apparently, the President was no longer concerned that corporate-tax-base erosion should hold up enactment of the statute.³⁴⁷ His change of heart could be attributed to a realization that the erosion of the corporate tax base would be less than originally estimated or that the benefits of REIT legislation would outweigh the costs of eroding the corporate tax base. The events leading up to the enactment of REIT legislation suggest that the possibility of corporate-tax-base erosion did not deter REIT legislation even though Congress and the President were aware of the tax-base-erosion arguments. To the extent they were concerned that REIT taxation might erode the corporate tax base, they addressed the concern by restricting

Sears that it would spin off its real estate assets into a REIT in taxable sale-leaseback); Sullivan, *supra* note 16, at 1105–07.

343. See WAYS & MEANS COMM. MAJORITY TAX STAFF, 113TH CONG., TAX REFORM ACT OF 2014: DISCUSSION DRAFT, SECTION-BY-SECTION SUMMARY 123 (Comm. Print 2014).

344. See *supra* text accompanying note 77.

345. See *supra* text accompanying notes 65–70, 72–76.

346. See *supra* text accompanying note 75.

347. Perhaps attributing such careful thought to President Eisenhower is inappropriate because the opposition to the REIT legislation appears to have come from Dan Throop Smith, an Under Secretary at Treasury at the time. See LYNN, BLOOMFIELD & LOWDEN, *supra* note 64, § 1.11. While Mr. Smith was at Treasury, the presidency opposed REIT legislation, but President Eisenhower signed the legislation shortly after Mr. Smith left Treasury in 1959. See *id.* This may suggest that President Eisenhower's stated opposition reflected the views of a single highly-influential individual, and that the concern for corporate-tax-base erosion was not widespread.

REIT activities to help ensure that REIT tax benefits only apply to passive income from real estate.³⁴⁸

Third, corporate-tax-base erosion is a misguided criticism of REIT taxation. One estimate concludes that lost tax revenue as a result of corporate-tax-base erosion could be as high as \$2 billion per year,³⁴⁹ but that estimate, as a critique of REIT taxation, is misleading, and corporate-tax-base erosion as a criticism of REIT taxation is misplaced. Corporate tax revenue is one source of government revenue, and a reduction of corporate tax revenue is significant only if it is not offset by tax revenue from other sources. Even though REITs may erode the corporate tax base, they also can increase tax revenues from other sources. REITs must distribute their taxable income,³⁵⁰ and individual REIT shareholders pay tax at higher rates than corporate shareholders.³⁵¹ The tax revenue lost from erosion of the corporate tax base can be offset by income resulting from the REIT distribution requirement and the higher tax rate on REIT dividends.³⁵² The tax-revenue effect of REIT spinoffs and conversions that divert income from corporations to REITs is very small. In fact, estimates of the tax revenue to be gained by the REIT reforms in the Camp Proposal would have been a measly \$200 million in 2015.³⁵³ That estimate is similar to other estimates of the tax-revenue effect of REIT spinoffs.³⁵⁴ In fact, the negative tax-revenue effect of REITs diverting income from corporations results from the favorable tax treatment afforded to tax-exempt entities and foreign investors who invest in REITs.³⁵⁵

348. See H.R. REP. NO. 86-2020, at 4 (1960) (reiterating that the Congress intended to restrict REIT taxation to passive investments); *supra* text accompanying notes 80–83 (discussing the purpose for enacting the REIT regime).

349. See Sullivan, *supra* note 16, at 1104.

350. See I.R.C. § 857(a)(1) (2012); *supra* text accompanying note 86.

351. See Borden, *Rethinking the Effect*, *supra* note 27, at 557–66; Borden, *Counterintuitive Tax Revenue Effect*, *supra* note 262, at 382.

352. See Borden, *Rethinking the Effect*, *supra* note 27, at 562–66; see also Baron, *supra* note 27, at 177–78, 186 (1973) (discussing the distribution requirement and higher tax rate on REIT dividends).

353. See STAFF OF J. COMM. ON TAXATION, 113TH CONG., ESTIMATED REVENUE EFFECTS OF THE “TAX REFORM ACT OF 2014,” JCX-20-14, at 10 (Comm. Print 2014) [hereinafter J. COMM., ESTIMATED REVENUE EFFECTS]. The \$2 billion estimate is closer to the overall tax-revenue effect of REIT taxation. See Borden, *Rethinking the Effect*, *supra* note 27, at 611–13.

354. See Borden, *Rethinking the Effect*, *supra* note 27, at 592–99 (estimating that the overall tax-revenue effect of REIT spinoffs is about \$250 million).

355. See Borden, *Rethinking the Effect*, *supra* note 27, at 566–83, 594–99 (deconstructing the stock ownership of REITs and regular corporations and showing that the special tax treatment afforded to tax-exempt and foreign investors accounts for the negative tax-revenue effect of REIT spinoffs and conversions).

Fourth, if the concern is loss of tax revenue, corporate-tax-base erosion is a red herring. REITs that form from partnerships, and therefore erode the partnership-income tax base, actually have a greater negative tax-revenue effect (approximately \$1.8 billion)³⁵⁶ than REITs that form from corporate conversions or spinoffs. Erosion of the partnership-income tax base results because some REIT shareholders qualify for tax benefits that are not available to members of partnerships.³⁵⁷ In particular, tax-exempt and foreign investors obtain tax benefits by investing in REITs that they could not obtain by investing in partnerships.³⁵⁸ Thus, the cause of both corporate-tax-base erosion and partnership-income-tax-base erosion is similarly the favorable treatment the tax rules afford to tax-exempt and foreign investors. The overall tax-revenue effect of REIT taxation and favorable treatment of tax-exempt and foreign investors is around \$2 billion a year, which is a minute percentage of total government receipts.³⁵⁹ Other benefits and the stated purposes of REIT taxation may outweigh its tax-revenue costs.

Fifth, the focus on corporate-tax-base erosion should not overshadow the expressed purposes of REIT taxation. Congress's expressed purposes for enacting the REIT legislation was to give more investors the opportunity to invest in diversified real estate portfolios and to channel more capital to the real estate markets.³⁶⁰ These benefits may have been more important to Congress than the potential loss of corporate tax revenue. Indeed the REIT industry extolls economic benefits provided by REITs, claiming they support nearly 1 million jobs and provide investment opportunities through pensions and retirement plans for 70 million Americans, including teachers and firefighters.³⁶¹ Additionally, more recent studies claim that publicly-traded

356. See Borden, *Rethinking the Effect*, *supra* note 27, at 599–611.

357. See Borden, *Rethinking the Effect*, *supra* note 27, at 608–11 (noting the differences between the two).

358. See *id.* (noting the difference between REITs and partnerships); Michael Hirschfeld & Shaul Grossman, *Opportunities for the Foreign Investor in U.S. Real Estate—If Planning Comes First*, 94 J. TAX'N 36, 46–47 (2001) (“A significant advantage of the REIT for foreign investors is that investment in a REIT does not cause the foreign investor to be engaged in a U.S. trade or business with respect to the entity’s operating income, unlike an investment in a partnership or LLC. The investor thus avoids the necessity of having to file annual income tax returns.”).

359. See Borden, *Rethinking the Effect*, *supra* note 27, at 611–12 (estimating that the tax-revenue effect of REIT taxation is 0.0729% of total government tax revenue).

360. See *supra* text accompanying notes 67–68, 80–83.

361. See *Economic Impact of REITs: REITs by the Numbers*, REIT, <https://www.reit.com/investing/reit-basics/reits-numbers> (last visited Sept. 18, 2015).

REITs help stabilize the commercial real estate market.³⁶² The small cost that results from REITs eroding the corporate tax base therefore appears to be offset by other benefits that REITs provide.

Finally, the concern about corporate-tax-base erosion is outdated. The concern about erosion of the corporate tax base was perhaps more meaningful in 1960, when Congress enacted the favorable REIT taxation regime. At that time, entity taxation applied to any entity that was separate from its owners, as determined using a multiple-factor corporate-resemblance test.³⁶³ The view that corporations were separate entities and partnerships were aggregates of their owners was more prominent then.³⁶⁴ Indeed, real estate investors (and mutual funds before them through RICs) felt compelled to seek preferential tax treatment through a separate REIT tax regime because the courts had held that business trusts were subject to corporate taxation.³⁶⁵ Today, separate legal status of an entity largely is irrelevant as tax law grants partnership flow-through taxation to limited liability companies that can have all of the entity attributes commonly attributed to corporations and are viewed as business entities separate from their owners.³⁶⁶

362. See *infra* text accompanying notes 446–86.

363. See *United States v. Kintner*, 216 F.2d 418, 420–24 (9th Cir. 1954) (finding that an association should be classified as a corporation for federal tax purposes because it had corporate attributes: (1) centralized management, (2) continuity of life, and (3) limited liability to the owners). Regulations promulgated in 1960 incorporated six factors (the first two of which are common with partnerships and corporations) into the test for corporation: “(i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests.” See *Treas. Reg. § 301.7701-2(a)(1)* (1960); Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 *HOFSTRA L. REV.* 405, 421–38 (2005) (recounting the history of these entity classification rules).

364. See Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 *GA. L. REV.* 719, 723–41 (2009) (briefly recounting the development of theories and laws of corporations, partnerships, and limited liability companies); Bradley T. Borden, *Residual-Risk Model for Classifying Business Arrangements*, 37 *FLA. ST. U. L. REV.* 245, 252–65 (2010) (describing the three tax regimes and how they apply to partnerships and corporations); Daniel S. Kleinberger, *The Closely Held Business Through the Entity-Aggregate Prism*, 40 *WAKE FOREST L. REV.* 827, 830–32 (2005) (discussing the history of the entity-aggregate dichotomy).

365. See *Morrissey v. Comm’r*, 296 U.S. 344, 360 (1935) (holding that a state-law trust was subject to corporate taxation because it had characteristics that resembled those of a corporation); *supra* text accompanying notes 53–58.

366. See *Treas. Reg. § 301.7701-1 to -3* (as amended in 2011, 2012, and 2006, respectively) (providing that a noncorporate U.S. entity, such as a limited liability company, will be treated as corporation only if it elects that classification); Kleinberger, *supra* note 364, at 841 (“[I]t does appear that the predominate forms of closely held businesses—general partnerships, close corporations, and LLCs—are indeed all entities now.”).

Corporate-tax-base erosion does not justify the attention that REIT taxation has received recently. Even though REITs may erode the corporate tax base, the REIT distribution requirement can generate income that offsets the effects of the eroded corporate tax base. Furthermore, Congress enacted REIT legislation to accomplish specific purposes. The non-tax benefits of REIT taxation may offset the small of negative tax-revenue effect that REIT taxation might have. Consequently, corporate-tax-base erosion is not a significant problem of REIT taxation.

B. Inequity of Preferential Treatment

The inequity argument embedded in the criticism of REITs is less salient than the corporate-tax-base-erosion argument, and it is more difficult to present as justification for reforming REIT taxation. As stated above, the inequity argument is embedded in the tax-base erosion argument, even though the arguments do not expressly refer to inequity.³⁶⁷ The inequity argument provides that REITs receive favorable treatment compared to regular corporations, but an equity analysis must also compare REITs to partnerships and other ownership arrangements. Those several points of reference take the wind out of the sails of the inequity claims against REIT taxation.

1. *REIT Taxation as a Classic Equity Conundrum.* The most prominent inequity argument cites the difference between corporate taxation and REIT taxation and claims that REITs erode the corporate tax base, and the tax treatment afforded REITs grants an unfair advantage to REIT investors.³⁶⁸ A proper

367. See *supra* text accompanying note 337.

368. See Cauble, *supra* note 27, at 173–78 (recommending REIT reform that would limit the types of income that qualify for conduit treatment of publicly traded entities); Jane G. Gravelle, *Non-Neutral Taxation and the Efficiency Gains of the 1986 Tax Reform Act—A New Look* 18–23 (NBER, Working Paper Series, No. 2964, 1989), <http://www.nber.org/papers/w2964.pdf> (concluding that 1986 tax reform eliminated different tax treatment of corporate and non-corporate capital and decreased inefficiency and dead weight loss); Martin A. Sullivan, *How Much Do Converted and Nontraditional REITs Cost the U.S. Treasury?* TAX ANALYSTS BLOG (Sept. 8, 2014), <http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/MSUN-9NRFWQ?OpenDocument> (claiming that REIT spinoffs and conversions reduced corporate tax liability by an amount between \$900 million and \$2.2 billion in 2014); Martin A. Sullivan, *REIT Conversions: Good for Wall Street. Not Good for America*, TAX ANALYSTS BLOG (Sept. 15, 2014), <http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/MSUN-9NXQLG?OpenDocument> (stating with respect to REIT spinoffs and conversions: “[T]here is the economic inefficiency that results from the unfairness of allowing a lucky few to escape the tax while others are left bearing the burden”).

equity analysis cannot, however, merely compare the tax treatment of real estate held by REITs to the tax treatment of real estate held by regular corporations to determine whether the law treats similar situations similarly.³⁶⁹ One of the original stated purposes of REIT legislation was to grant real estate investors tax treatment that was similar to the tax treatment afforded RIC investors,³⁷⁰ so Congress intended to treat the assets of REITs differently from the assets held by regular corporations but similarly to assets held by RICs. As Figure 7 illustrates, a comparison of REITs to corporations on the one hand and to RICs on the other does not conclusively establish that the law should treat REITs in the same manner that it treats either of these other types of arrangements. Thus, REITs create a classic equity conundrum.³⁷¹

369. See Bradley T. Borden, *Quantitative Model for Measuring Line-Drawing Inequity*, 98 IOWA L. REV. 971, 976–80 (2013) (considering the difficulty of drawing lines that separate arrangements that receive different tax treatment); Bradley T. Borden, *The Like-Kind Exchange Equity Conundrum*, 60 FLA. L. REV. 643, 671 (2008) [hereinafter Borden, *Equity Conundrum*] (discussing inequity analyses in the context of multiple comparison points).

370. See *supra* text accompanying notes 67, 81.

371. See Borden, *Equity Conundrum*, *supra* note 369, at 660–95 (describing the equity conundrum raised by tax-free exchanges, which the law treats as continued ownership of the same property instead of as the exchange for one property for non-like-kind property, and how the law could address that conundrum).

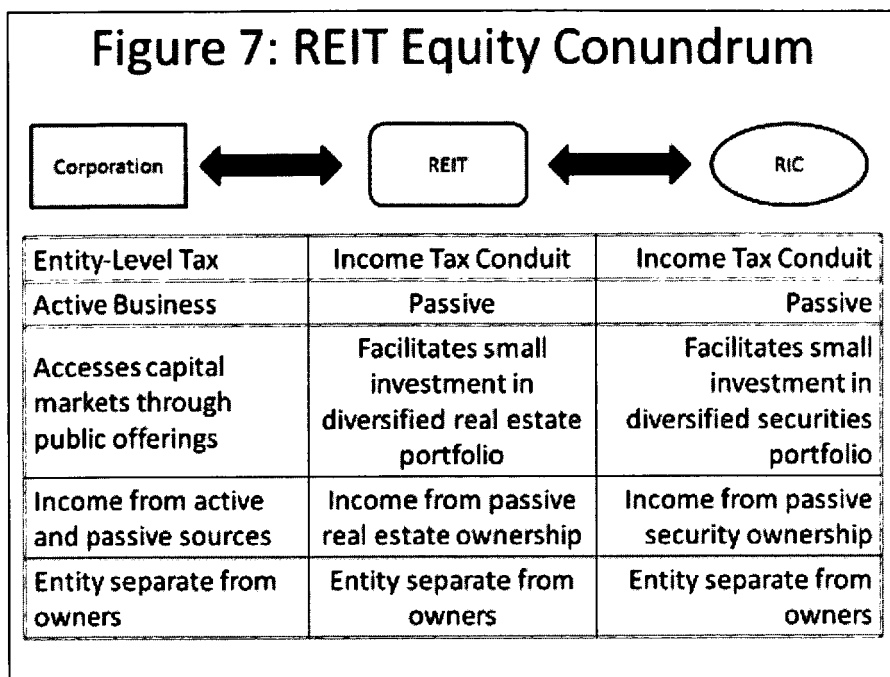


Figure 7 suggests that perhaps the most striking difference between corporations on the one hand and RICs and REITs on the other hand is the level of business activity and the purpose of the entities. That raises the question of whether the type of income should determine whether an entity should be subject to entity-level taxation and whether the level of business activity should define what type of property should qualify for REIT treatment. Many of the provisions of the REIT qualification test restrict a REIT's level of activity.³⁷² Although those considerations may not appear relevant to facilitate small investment in a diversified portfolio or to channel capital to real estate markets, Congress clearly intended to limit the benefit of REIT taxation to passive investments in real estate. Active corporations can access capital provided by smaller investors through RICs, so they are not disadvantaged compared to REITs. Thus, the relevant differences in activity would appear to be the characteristic that justifies treating REITs and active corporations differently. REITs may now provide more services to the tenants of property they hold

372. See Siemann, *supra* note 27, at 275–77 (explaining the different requirements that REITs have to follow and indicating that Congress wanted to limit the favorable tax treatment given to REITs to companies that are passively invested in real estate and not businesses that engage in active trade).

directly or indirectly through taxable REIT subsidiaries.³⁷³ Those services, when considered in total, may make some REITs look like active businesses. Nonetheless, income recognized by taxable REIT subsidiaries for business activities is subject to an entity-level tax.³⁷⁴

Simply comparing REITs to corporations in today's environment is inappropriate because many REITs could form as partnerships instead of becoming corporations.³⁷⁵ Therefore, the inequity analysis must also consider whether REITs should be compared to partnerships instead of corporations.³⁷⁶ As Figure 8 illustrates, some REIT attributes are similar to corporations and some are similar to partnerships, so the law must choose whether to tax REITs more like corporations or more like partnerships. Today a significant amount of real estate is owned through partnerships and limited liability companies.³⁷⁷ Those are generally closely held entities held by the wealthiest members of society,³⁷⁸ but they can also be publicly traded.³⁷⁹ If an arrangement incorporates, it will be subject to the entity-level tax; if it becomes a publicly traded partnership, it can escape an

373. See *supra* Part II.C.2, 6 (describing the evolution of services REITs can provide).

374. See *supra* text accompanying notes 288–93 (describing the entity-level tax).

375. See *supra* text accompanying notes 351–57 (noting that tax revenue loss from erosion of corporate tax is small compared to the erosion from REITs that form from partnerships).

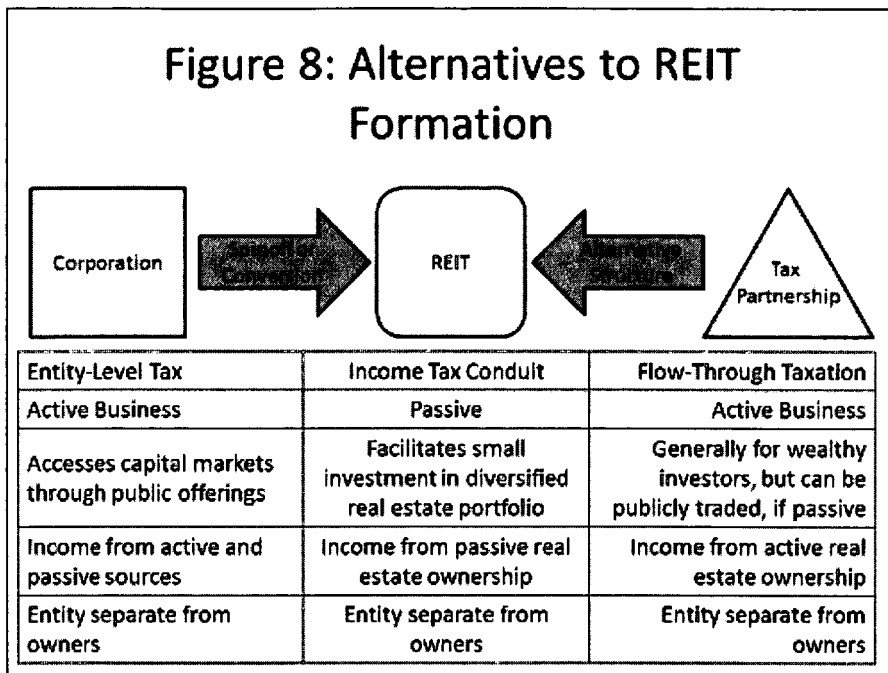
376. See Cauble, *supra* note 27, at 154–55 (recognizing that REITs are like both corporations and publicly traded partnerships); Borden, *Equity Conundrum*, *supra* note 369, at 660–95 (illustrating that the equity analysis must consider multiple alternatives when a tax situation is similar to more than one situation).

377. See *SOI Tax Stats—Partnership Statistics: Table 4. Partnerships with Net Rental Real Estate Income (Loss), by Selected Industrial Group, Tax Year 2012*, <http://www.irs.gov/uac/SOI-Tax-Stats-Partnership-Statistics-Rental-Real-Estate-Income-Partnerships-with-Rental-Real-Estate-Income> (last updated Aug. 28, 2015) [hereinafter *Partnership Tax Stats*] (showing that partnerships had \$488 billion of gross rents from real estate in 2012).

378. To avoid registration requirements, partnerships would generally avoid general solicitation and advertising and only accept investments from accredited investors. See Rober C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 277 n.234 (2007) (citing 17 C.F.R. § 230.501(e)(1)(iv) (2006) as authority for excluding accredited investors from the general rules governing securities regulation). An accredited investor is an individual with a net worth (or joint net worth with spouse) of more than \$1 million or at least \$200,000 of income (or \$300,000 of joint income with spouse) in the two preceding years and expects the same level in current year. See 17 C.F.R. § 230.501(a)(5), (6) (2014). Of the 1.5 million partnerships, 99.99% are closely held. See *Partnership Tax Stats*, *supra* note 377 (providing that about 1.5 million partnerships filed tax returns in 2012); *PTPs Currently Traded on U.S. Exchanges, MLP Funds and MLP Indexes*, NAT'L ASS'N OF PUBLICLY TRADED P'SHIPS, <http://www.naptp.org/PTP101/CurrentPTPs> (last updated July 22, 2015) (listing about 150 publicly traded partnerships, of which only 18 are real estate and financial).

379. See I.R.C. § 7704 (2012) (governing publicly traded partnerships).

entity-level tax if and only if a sufficient portion of its income is from passive, REIT-like sources.³⁸⁰



Tax law generally treats publicly traded partnerships as corporations and subjects their income to an entity-level tax.³⁸¹ The law exempts publicly traded partnerships from that entity-level tax, however, if at least 90% of a partnership's income is from passive sources, including rents and gains from the sale of real property.³⁸² The rules governing publicly traded partnerships incorporate the REIT definition of rents from real property, but they have more liberal rules regarding services, which do not prevent publicly traded partnerships from directly providing customary tenant services.³⁸³ Nonetheless, rents for publicly traded partnerships only include payments for customary tenant services provided by publicly traded partnerships to their tenants, and do not include payments for noncustomary tenant services whether provided by an

380. See § 7704.

381. See § 7704(a).

382. See § 7704(c)(2), (d)(1)(C)–(D).

383. See § 7704(d)(3)(A).

independent contractor or otherwise.³⁸⁴ Consequently, investors in publicly traded partnerships get the same flow-through advantage afforded to REITs,³⁸⁵ but greater restrictions apply to the types of services that a REIT may provide directly to tenants. The equity analysis must consider whether the law that treats REITs and partnerships differently is justified and whether the law should treat REITs more like partnerships (either those that are publicly traded or those that are privately held).

Finding the right point of comparison among the various types of entities that REITs resemble in some way may be a challenge. A focus on entity attributes would appear to be inadequate to solve the inequity conundrum because each type of arrangement can have similar entity attributes.³⁸⁶ Instead, an entity's type of income may be a better point of reference. If entities that have only passive types of income should qualify for flow-through or conduit taxation, then REITs, publicly traded partnerships, and RICs, rightly qualify for that treatment, and corporations that have active income do not. Consequently, even though tax law treats REITs and regular corporations differently, that different treatment alone does not validate the inequity argument against REIT taxation because REITs are also like RICs and partnerships in some ways.

2. *Inequity of Gotcha Legislation.* The equity analysis should also consider how changes to the law would treat entities before and after the change. Legislation that would prohibit tax-free

384. See H.R. REP. NO. 100-795, at 401 (1988) ("With respect to the definition of real property rents, it is clarified that non-application of the independent contractor rule (section 856(d)(2)(C)) does not affect the requirement that the nature of the income be rent. Thus, the fact that the independent contractor rule does not apply for purposes of determining the qualifying income of a partnership does not mean that amounts received by a partnership, which amounts include amounts for services that are not customarily furnished in connection with the rental of real property, constitute real property rents (section 856(d)(1)(B)). For example, where the partnership receives or accrues amounts attributable to the performance of services that are not customarily furnished in connection with the rental of real property (e.g., to the extent that the furnishing of hotel or motel services causes amounts not to be treated as rents from real property under present law), then the partnership is treated as not receiving qualifying income.").

385. Nonetheless, some commentators argue that the definition of qualifying income for publicly traded partnerships is too broad, deviates from the stated purpose of the regime, and should be narrowed. See Emily Cauble, *Redefining Qualifying Income for Publicly Traded Partnerships*, 145 TAX NOTES 107, 107 (2014). They recommend reform of publicly traded partnerships as a way of raising revenue. See *id.*

386. For example, tax partnerships, RICs, and REITs can be limited liability companies, which have many of the attributes of a corporation. See Fisher, *supra* note 43, at 338–42; *supra* text accompanying notes 89, 363–66 (noting the different entities a REIT can be).

REIT spinoffs would constitute a form of “gotcha legislation.” Such a change in the law would prevent corporations that held real estate from obtaining tax treatment that other corporations had obtained by already spinning off their real estate assets. It would also lock in corporate tax treatment for entire entities that formed as corporations with real estate and treat them differently from those that formed using the post-spinoff structure with an operating corporation leasing property from a REIT (see Figure 9). Preventing corporations from spinning off real estate assets would therefore lock them into a form that they could not have foreseen as favorable. The law should not be out to get property owners who could not foresee the developments that have occurred in the REIT industry, nor should it disfavor business owners who, at the inception of their businesses, cannot afford the type of advice required to set up or include a REIT.

3. *Transactional Inequity.* The equity analysis should also consider whether tax law treats different types of transactions appropriately. For instance, tax law favors REIT spinoffs over sale-leasebacks. A corporation could accomplish the same economic arrangement that it accomplishes with a REIT spinoff by simply selling property to a REIT and then leasing it back. Even though a sale-leaseback is economically equivalent to a REIT spinoff, tax law grants favorable tax treatment to the REIT spinoff, but not to the sale-leaseback.³⁸⁷ That disparate treatment generally favors REIT spinoffs over sale-leasebacks,³⁸⁸ but such favored treatment of a transaction does not appear to create any serious inequity because corporations generally should be able to spin off real estate instead of having to sell it. If the cost of spinning off property exceeds the cost of a sale-leaseback, however,

387. In some situations, however, a sale-leaseback can qualify for nonrecognition under I.R.C. § 1031. See, e.g., *Century Elec. v. Comm'r*, 192 F.2d 155 (8th Cir. 1951); *Mo. Pac. R.R. Co. v. United States*, 32 A.F.T.R.2d 73-5816 (Ct. Cl. 1973) (holding that the sale-leasebacks were tax-free exchanges). But see *Jordan Marsh Co. v. Comm'r*, 269 F.2d 453, 456-57 (2d Cir. 1959) (classifying transaction as a sale rather than an exchange because record lacked findings that cash received by taxpayer fully equated to fee taxpayer conveyed to vendee-lessor and leaseback called for a rent fully equal to rental value of the property); *City Investing Co. v. Comm'r*, 38 T.C. 1, 9 (1962) (holding that sale-leasebacks were not tax-free exchanges). See also BRADLEY T. BORDEN, *TAX-FREE LIKE-KIND EXCHANGES* ¶3.2[3][b], at 3-19 (2d ed. 2015) (discussing the tax treatment of sale-leasebacks and the factors that determine whether they are tax-free exchanges).

388. Nonetheless, some corporations' tax and non-tax situation may justify using a sale-leaseback structure to remove real estate assets from the corporation. See, e.g., Elliott, *supra* note 342, at 751 (reporting on the announcement that Sears Holdings Corp. would sell real estate assets to a REIT to help alleviate its cash-shortage problem and lease them back).

the law favors wealthier corporations who can afford the costs to cover the complexity of a REIT spinoff.³⁸⁹ Taxpayers would also presumably prefer to have a choice. If the property has built-in loss, the corporation would prefer to do a sale-leaseback and recognize the loss.³⁹⁰ Without the opportunity to transfer property tax-free, some corporations would not be able to justify the spinoff because the tax benefit obtained through REIT ownership would not offset the tax incurred on the sale.³⁹¹ Spinoffs are a partial way around that lock-in effect.³⁹² The movement of real estate from operating corporations to REITs after the IRS blessed tax-free spinoffs of real estate may be evidence that the lock-in effect dissuades property owners from transferring real estate into the hands of the most tax-efficient owner.³⁹³ The law would be inequitable if it allowed some corporations to spinoff real estate assets but prevented others from doing the same thing.

C. *Efficiency Aspects of Separate Operations and Ownership*

The current REIT rules encourage multiple-entity structures that separate operations from ownership with either the use of a taxable REIT subsidiary or a long-term lease. That separation creates costs and provides benefits, with uncertain net results. “The underlying idea of a REIT [spinoff] is that the efficient owner of property can be different from the efficient user of the property and taxes can be a major contributor to this divergence.”³⁹⁴ An efficient tax regime should not, however, favor one form of

389. See I.R.S. Priv. Ltr. Rul. 2014-11-002 (Dec. 13, 2013); I.R.S. Priv. Ltr. Rul. 2013-37-007 (Sept. 28, 2012) (granting favorable tax treatment to complex REIT spinoffs); Andrea Macintosh Whiteway, Caroline H. Ngo & Britt Haxton, *REIT (Real Estate Investment Trusts) Spin-Offs: Recent Transactions and IRS Rulings*, NAT'L L. REV. (Nov. 12, 2014), <http://www.natlawreview.com/article/reit-real-estate-investment-trusts-spin-offs-recent-transactions-and-irs-rulings> (describing the complex nature of recent REIT spinoffs).

390. To obtain loss treatment, the corporation must ensure that the sale-leaseback is not a tax-free like-kind exchange. See *supra* note 387 (discussing cases that have addressed the matter).

391. Some people familiar with REIT spinoffs claim they are the provinces of ailing companies that have tax losses. See, e.g., Elliott, *supra* note 342, at 751 (reporting that Sears plans to do a sale-leaseback of its property, apparently unconcerned about generating taxable gain on the disposition of its real estate because it has sufficient tax losses to offset the gain). An anonymous voicemail left with the Author on February 1, 2015, claimed that all REIT spinoffs have been by companies with tax losses.

392. See Goolsbee & Maydew, *supra* note 261, at 453–55.

393. See *id.*, at 442–43. But see *supra* note 391 (noting that some people have claimed that REIT spinoffs are the provinces of ailing companies).

394. See Goolsbee & Maydew, *supra* note 261, at 453.

ownership over another,³⁹⁵ but the current system favors OpCo-PropCo structures,³⁹⁶ taxable REIT subsidiary structures, and UPREIT structures over other, economically equivalent transactions and arrangements. By simply changing the legal form of an arrangement, such as creating a wholly-owned taxable REIT subsidiary, a REIT can perform all of the services that other REITs have to hire an independent contractor to perform and which a publicly traded partnership can perform directly.³⁹⁷ The efficiency concern is that the formalism encourages REITs to use structures that may not have any non-tax justification, so they may create deadweight loss.³⁹⁸ As the following discussion reveals, however, structures that separate operations and ownership may also create transparency and otherwise mitigate agency costs.

1. *Separation Creates Costs.* REIT taxation creates incentives for property owners to separate real estate ownership from operations. Most separations are formalistic, however, as the operating entity retains control over the real estate through long-term leases or some other mechanism, or the REIT uses a taxable REIT subsidiary to manage and operate the property.³⁹⁹ Some commentators observe that separating real estate from

395. See Louis Kaplow, *Taxation*, in 1 HANDBOOK OF LAW AND ECONOMICS 647, 651–58 (A. Mitchell Polinsky & Steven Shavell eds., 2007); David Gamage, *How Should Governments Promote Distributive Justice?: A Framework for Analyzing the Optimal Choice of Tax Instruments*, 68 TAX L. REV. 1, 82 (2014); Gravelle, *supra* note 368.

396. The OpCo-PropCo structure results from a REIT spinoff with an operating corporation (OpCo) leasing the property from a REIT (PropCo). See *infra* Figure 9, Structure (2).

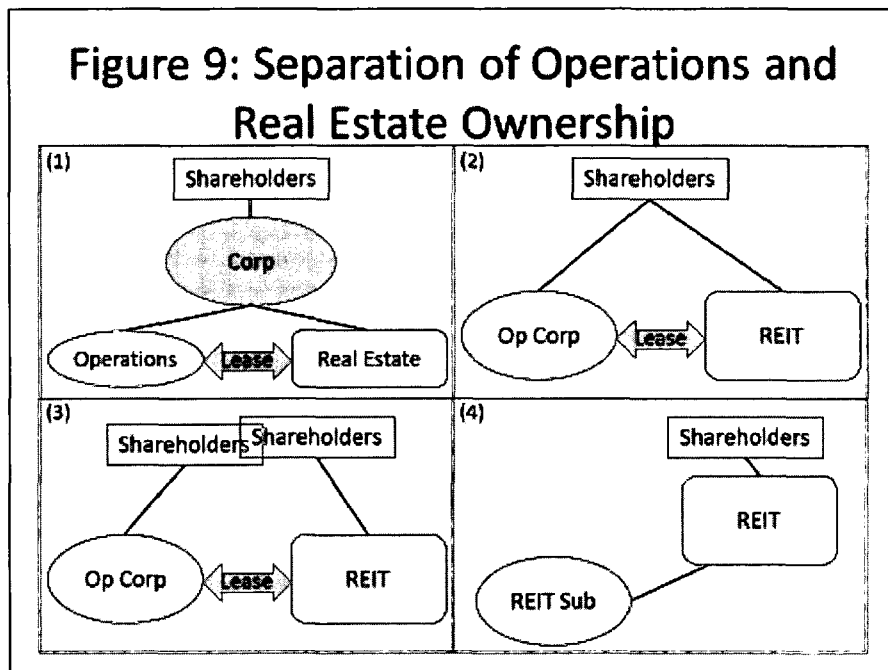
397. See *supra* text accompanying notes 382–85. Because the law does not restrict the type of services that a subsidiary of a publicly traded partnership can perform, a publicly traded partnership can form a subsidiary to provide any type of services to the partnership's tenants.

398. Martin A. Sullivan, *The Economic Inefficiency of REIT Conversions*, 144 TAX NOTES 1229, 1229–30 (2014) (claiming that the REIT rules limit REIT investment opportunities, encourage investment in real estate over other investments, and increase tax-planning and compliance costs). Deadweight loss, or excess burden, is the loss of welfare above and beyond tax collected when tax law distorts economic behavior. See HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 331 (8th ed. 2008).

399. See, e.g., I.R.S. Priv. Ltr. Rul. 2013-20-007 (Feb. 11, 2013) (ruling with respect to a REIT conversion of a publicly-traded private prison company that would manage the property through a taxable REIT subsidiary following the conversion); I.R.S. Priv. Ltr. Rul. 2013-17-001 (Jan. 16, 2013) (ruling with respect to a conversion of a publicly-traded corrections company that would manage the property through a taxable REIT subsidiary following the conversion); I.R.S. Priv. Ltr. Rul. 2013-37-007 (Sept. 28, 2012) (describing a REIT spinoff that included a long-term contract granting the operating company continued use of the property); Windstream News Release, *supra* note 332 (providing that the operating corporation will enter into a long-term triple-net lease with the REIT).

operations may raise agency and other costs,⁴⁰⁰ which could explain why more corporations have not yet spun off their real estate holdings. This suggests that even though spinoffs provide an opportunity for some corporations to legally separate operations and real estate, other corporations cannot take advantage of that opportunity because of cost restrictions.

Consider four different corporate ownership structures depicted in Figure 9, three of which legally separate operations and real estate ownership for tax purposes, one of which can separate ownership and management, and all of which can provide common control of operations and real estate.⁴⁰¹



The first structure (1) is a corporation that owns both the operations and real estate assets, either directly or through wholly-owned subsidiaries one of which conducts the operations and the other of which owns the real estate. This structure provides common control of both the operations and the real estate, but it typically does not separate them for tax purposes.

400. See Goolsbee & Maydew, *supra* note 261, at 450–51.

401. The separation may be by law only because one party or group of owners may retain control of both ownership and operations, so the separation may be legal but not economic or substantive.

The income from the operations and ownership would be subject to corporate tax.⁴⁰² The second structure (2) (an OpCo-PropCo structure) is the result of a REIT spinoff (or carefully crafted pre-formation structure). The spinoff creates a new REIT and the original corporation continues as an operating corporation. Immediately following the spinoff, the shareholders of the original corporation own all of the stock of the operating corporation and the REIT (but over time the shareholding might diverge and become similar to the third structure (3)). A long-term lease, with options to renew, gives the operating corporation practical control of the real estate for a long time. If the assets are unique to the operating corporation, they are even more locked in because the REIT would have few, if any, other buyers for its property. Income from the operations of this structure would be subject to corporate tax,⁴⁰³ but the income from the real estate would flow through to the REIT shareholders with the REIT dividends.⁴⁰⁴

The third structure (3) results over time after a REIT spinoff as shareholders sell their interests and the identical, overlapping ownership of the two entities diverges.⁴⁰⁵ Common ownership ends as the overlap of operating corporation shareholders and REIT shareholders diminishes.⁴⁰⁶ Even though the operating

402. See I.R.C. §§ 11, 856(l) (2012).

403. See §§ 11, 856(l).

404. See *supra* notes 84–87.

405. Common ownership of an operating corporation and a stapled REIT would not, however, diverge over time. The stock of the operating corporation and stapled REIT trade as one, so the stock of both entities track each other, and the two entities are under common management. See Wern, *supra* note 27, at 725–26. Prior to June 30, 1983, property owners could form stapled REITs, which tied a REIT to an operating corporation through various agreements, but the Deficit Reduction Act of 1984 prohibited future formation of stapled REITs by treating the corporation and REIT as a single entity for REIT testing purposes. See Tax Reform Act of 1984, Pub. L. No. 98-369, § 136(a), 98 Stat. 494, 669–70 (codified at I.R.C. § 269B(a)(3), (c)(3) (Supp. II 1984)). The law defines stapled entities as ones that have more than 50% of their outstanding value under common ownership. See I.R.C. § 269B(c)(2). Stapled REITs that existed prior to June 30, 1983 were able to purchase additional real estate and continue to grow. See Michael T. Madison, Jeffry R. Dwyer & Steven W. Bender, *Securitization of Commercial Real Estate*, in 1 LAW OF REAL ESTATE FINANCING § 4:34 (2014). In 1998, Congress leveled the playing field by prohibiting stapled REITs from acquiring additional property after March 26, 1998. See Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 7002, 112 Stat. 685, 827. Consequently, stapled REITs, if any remain, are not as important today as they were a few of decades ago.

406. See Goolsbee & Maydew, *supra* note 261, at 446. But see PETER M. FASS, MICHAEL E. SHAFF & DONALD B. ZIEF, *Stapled and “Clipped” REITs*, in REAL ESTATE INVESTMENT TRUSTS HANDBOOK § 6:77 (2014) (reporting the creation of a new paired-share REIT that will avoid being classified as a stapled REIT by ensuring that not more than 45% of the stock of the REIT will trade with stock of the operating corporation). Extended Stay America, Inc. and ESH Hospitality, Inc. offered paired shares in their recent IPO. See

corporation and the REIT are no longer under common ownership and control, the operating corporation can still largely control the real estate as a practical matter and for a long time through the long-term lease and the options to renew it. Consequently, even though the operating corporation and the REIT are not under common control, the shareholders of the operating corporation ultimately control both the operations and the real estate assets, so practically, they are under common control. Income from the operations is subject to corporate tax,⁴⁰⁷ but income from the real estate flows through to the REIT shareholders with REIT dividends.⁴⁰⁸ The fourth structure (4) inverts the ownership. The shareholders own the REIT directly and the REIT owns a subsidiary that manages the property.⁴⁰⁹ The income of the subsidiary is subject to corporate tax,⁴¹⁰ but the REIT's distributed rental income flows through to its shareholders free of entity-level taxation.⁴¹¹ Because the REIT wholly owns the subsidiary, it controls both the management and the real estate, but tax law treats them as being separate.

Inefficiency is a serious matter because it strikes at the heart of one of the fundamental purposes of REIT taxation. The efforts REITs expend to separate ownership and control add complexity to the structures, increase the cost of an investment, and dilute the value of an investment. Those costs result in a lower return for investors and less capital flowing directly to real estate markets. Those costs are unjustified, if the only purpose and result of incurring the costs is to reduce taxes. Even though the current structures create costs, they also appear to provide some non-tax benefits that may outweigh or offset some of their costs, so the complex structures may not create deadweight loss.

2. Separation Promotes Diversification and Transparency. Even though separating operations and ownership may increase costs, it also provides investors opportunities to specialize their investments in real estate and allows corporations to specialize in

Extended Stay Am., Inc. & ESH Hosp., Inc., Final Prospectus (Nov. 12, 2013), <http://www.sec.gov/Archives/edgar/data/1507563/000119312513440419/d565367d424b4.htm>.

407. See § 11.

408. See *supra* text accompanying notes 84–87.

409. See, e.g., I.R.S. Priv. Ltr. Rul. 2013-20-007 (Feb. 11, 2013); I.R.S. Priv. Ltr. Rul. 2013-17-001 (Jan. 16, 2013) (managing property through a REIT subsidiary).

410. See §§ 11, 856(l).

411. See *supra* text accompanying notes 84–87. Any redetermined rents attributable to the services provided by the taxable REIT subsidiary will, of course, be subject to a 100% tax. See § 857(b)(7).

property ownership and operations.⁴¹² Specialized ownership and operations are partially undermined by structures that lock in control of the real estate and operations under common ownership or through other arrangements,⁴¹³ but the separation provides greater choice for investors and other real efficiency benefits. For instance, the separation allows the operating corporation to remove liabilities from its balance sheet.⁴¹⁴ Even though the operating corporation may have a long-term obligation in the form of a lease of assets that are essential to its operations (e.g. Windstream cannot provide telecommunication services without the networks), rating agencies may treat a long-term lease differently from other liabilities. Such different treatment may result in better debt ratings, which reduce the operating corporation's cost of capital following the spinoff. The structure following a spinoff also creates different claims to cash flows and residual upsides and downsides for the respective capital providers to the operating corporation and REITs. Consequently, separating operations and ownership may provide several financial benefits to investors.

Separation of operations and ownership also facilitates portfolio diversification. According to portfolio theory, diversification is the gold standard of investing strategies.⁴¹⁵ As one example, portfolio experts recommend that 10% to 15% of an individual's investment portfolio should consist of real estate holdings in REIT funds.⁴¹⁶ REIT spinoffs enhance investors' ability to diversify their portfolios.⁴¹⁷ REIT spinoffs allow a person to acquire both the stock of the operating corporation and the stock of the new REIT, which may create the appearance of greater portfolio diversity. The spinoff does not, however, change the composition of the underlying assets of the investor who held the corporate stock prior to the spinoff (investors in corporations indirectly own the corporations' real estate assets). Nonetheless,

412. See Goolsbee & Maydew, *supra* note 261, at 453–54.

413. See *supra* text accompanying notes 403–08.

414. See, e.g., Windstream News Release, *supra* note 332 (providing that the spinoff will reduce Windstream's debt by approximately \$3.2 billion and increase its free cash flow).

415. See generally Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952) (introducing portfolio theory).

416. See BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET, 368–71 (1999). Other research supports adding equity REITs to an investment portfolio, even though REITs do not provide a direct substitute for unsecuritized real estate. See CHAN, ERICKSON & WANG, *supra* note 13, at 215–18.

417. See Joe Light, *Use REITs to Invest Like a Property Mogul*, WALL ST. J. (June 22, 2015, 10:17 AM), http://www.wsj.com/article_email/use-reits-to-invest-like-a-property-mogul-1434731193-lMyQjAxMTI1MTI0MjcyMzIzWj.

over time following the spinoff, shareholders may sell off shares of the operating corporation or REIT to rebalance their portfolios.⁴¹⁸ Also, following a spinoff, REITs may diversify their holdings by acquiring other real estate, or REITs (i.e., those with the largest taxable REIT subsidiaries) may provide more tenant services and begin to function more like operating corporations. Some analysts claim that including REITs in an investment portfolio can lower overall portfolio risk and improve returns,⁴¹⁹ so REIT spinoffs provide an opportunity for investors to invest specifically in business operations or real property.

The opportunity to invest more specifically in a particular type of asset is another benefit that REIT taxation provides. If real estate is held in operating corporations, investors may not be able to adequately determine the value of the real estate relative to other corporate assets. Separate entities that provide specific information about operations and ownership respectively should provide better information to investors, and investors should be able to modulate their investment holdings to suit their personal preferences with greater precision. Separation of operations and ownership therefore facilitates micro diversification of investors' portfolios. Small investors could, for instance, choose to expand their holdings of billboard REITs, data center REITs, or any other type of specialty REIT according to their own preferences. A broad definition of REIT real property in fact allows individual investors to hold a portfolio of only specialized real estate or a portfolio of diversified real estate holdings. Thus, the separation of operations and ownership provides investment opportunities to individual investors that they would not have otherwise. These additional opportunities for individual investors are consistent with the original purpose of REIT taxation.⁴²⁰

REIT spinoffs and the formation of REITs in general also appear to provide monitoring benefits as sophisticated investors require REITs to provide more information and use that

418. See Borden, *Rethinking the Effect*, *supra* note 27, at 584 ("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.") (citing William F. Sharpe, *Adaptive Asset Allocation Policies*, 66 FIN. ANALYSTS J. 45, 45-47 (2010)).

419. See Hsuan-Chi Chen, Robert (Chi-Wing) Fok & Chiuling Lu, *An Analysis of Lockups in REIT IPOs*, 43 J. REAL EST. FIN. & ECON. 359, 372 (2011); Stephen Lee & Simon Stevenson, *The Case for REITs in the Mixed-Asset Portfolio in the Short and Long Run*, 11 J. REAL EST. PORTFOLIO MGMT. 55, 60-67 (2005) (finding that including REITs in an investment portfolio provides both return enhancement and risk reduction).

420. See *supra* notes 65-70 and accompanying text.

information to influence REIT behavior.⁴²¹ Additional information and monitoring help reduce the risk-related fluctuations in the price of REIT stock,⁴²² and institutional ownership helps create value and transfer wealth “through the increased opportunity for REIT managers to communicate with a less-dispersed, more-sophisticated investor base.”⁴²³ As the number of financial analysts following an equity REIT’s stock increases (and the information about the REIT increases as a result), the risk related to that stock declines.⁴²⁴ Thus, as a result of REIT spinoffs, investors will have more information about the assets transferred to REITs and they will be able to better monitor the management of that property. The greater transparency may lead to more efficient property management. Consequently, separating real estate from corporate operations may increase the value of the real estate. That increase in value may offset any tax revenue lost as a result of REIT taxation generally and REIT spinoffs in particular.

Using complex structures to separate operations and property ownership create a mixed bag. The separation generates transaction costs and may create agency costs as between the operator and owner of the property. The separation also provides for specialized ownership and operations and results in greater information and monitoring of the real estate, which may reduce agency costs between investors and managers of both the operating entity and the REIT. Because separating operations from ownership appears to simultaneously enhance and diminish inefficiency, net efficiency effect of separating operations from ownership is unclear. Therefore, an efficiency argument does not justify condemning REIT taxation.

421. See, e.g., Zhilan Feng et al., *Institutional Monitoring and REIT CEO Compensation*, 40 J. REAL. EST. FIN. ECON. 446, 474–76 (2010) (finding that institutional investment in REITs affects CEO compensation).

422. See CHAN, ERICKSON & WANG, *supra* note 13, at 107; Crain, Cudd & Brown, *supra* note 13, at 281–83 (finding that the greater presence of institutional investors in the REIT market caused unsystematic risk to play a lesser role in REIT returns).

423. See Downs, *supra* note 234, at 640.

424. See Terence Khoo, David Hartzell & Martin Hoesli, *An Investigation of the Change in Real Estate Investment Trust Betas*, 21 J. AM. REAL EST. & URB. ECON. ASS’N 107, 117–25 (1993) (using variability of returns as a measure of risk). But see David H. Downs & Z. Nuray Guner, *Is the Information Deficiency in Real Estate Evident in Public Market Trading?*, 27 REAL EST. ECON. 517, 539 (1999) (concluding that trade informativeness increases in the number of analysts following a REIT, but that does not solve the adverse-selection problem faced by REIT investors).

D. Bad Optics of REIT Taxation

Because the tax-revenue effect, inequity, and inefficiency arguments do not justify condemning REIT taxation, the ire directed toward REITs appears to be the result of bad optics.⁴²⁵ Public perception of a tax regime has not traditionally been a criterion of the quality or validity of the regime, and it should not carry influence in the current decision-making process regarding REITs. REITs are conduit entities, so they are not subject to the entity-level tax. A corporation that spins off its real estate would appear to be making a pure tax play, but assessing the tax effect of a REIT spinoff requires sophisticated analysis,⁴²⁶ with views of the effect diverging significantly.⁴²⁷ A proper assessment of REIT spinoffs and conversions and REIT taxation generally requires careful analysis of the tax-revenue effect.

Without conducting sufficient analyses to assess the tax-revenue effect of REIT spinoffs and conversions, the media focused on the appearance of the transactions,⁴²⁸ which look bad because they appear to erode the corporate tax base. This type of eye test does not take into account the tax-revenue offset obtained from the higher tax rate imposed on REIT shareholders, the effect of the REIT distribution requirement, or the effect of the stock price surge following the announcement of a REIT spinoff.⁴²⁹ Identifying and quantifying the effect REITs have on the

425. See Elliott, *supra* 340, at 22 ("It's almost as if perception matters more than the bottom line—there are indications that either the overall loss of tax revenue to the fisc from these conversions hasn't been significant or that it's something that Congress has decided is worth the trade-off. It's hard to equate REIT/PTP conversions with inversions because the IRS gave its blessing to many of the conversions, but avoidance is a dirty word that REIT and PTP players will have to find a way to negotiate if they want to secure their futures.").

426. See Borden, *Rethinking the Effect*, *supra* note 27, at 562–99 (presenting a dynamic analysis for evaluating the tax-revenue effect of REIT spinoffs); Goolsbee & Maydew, *supra* note 261, at 443.

427. See J. COMM., ESTIMATED REVENUE EFFECTS, *supra* note 353, at 10 (estimating that the Camp Proposal would increase tax revenue by \$5.9 billion over ten years with a \$200 million increase in 2015, by prohibiting REIT spinoffs); Borden, *Rethinking the Effect*, *supra* note 27, at 598 (estimating that the tax-revenue effect of REIT spinoffs and conversions in 2013 was no more than \$260 million); Goolsbee & Maydew, *supra* note 261, at 451 (estimating in 2002 that potential lost tax revenue from REIT spinoffs could be as great as \$2.3 billion); Sullivan, *supra* note 16, at 1104 (estimating the effect of REIT spinoffs and conversions to be between \$900 million and \$2.2 billion based upon 2014 profit levels).

428. See *supra* note 3.

429. See Borden, *Rethinking the Effect*, *supra* note 27, at 583–86 (incorporating those variables into a dynamic analysis of the tax-revenue effect of REIT taxation); see also Borden, *Counterintuitive Tax Revenue Effect*, *supra* note 262, at 382–84 (showing how the tax-revenue effect of a REIT spinoff can be positive even though the spinoff erodes the corporate tax base).

partnership-income tax base is much more complex and nuanced.⁴³⁰ Even though REITs appear to draw down tax revenue more from partnership-income-tax-base erosion than they do from corporate-tax-base erosion, the difficulty of detecting that problem allows the problem to escape the eye test. Casual observers might be less apt to examine partnership-income-tax-base erosion because the idea of REITs eroding the tax base of another type of flow-through entity is counterintuitive. Consequently, REITs do not look bad compared to partnerships at first blush. Because the tax-base-erosion arguments focus only on the corporate tax base, the arguments appear to stem from bad optics and lack validity.

Modifying REIT taxation based upon lay commentators' reactions to bad optics could significantly affect the achievement of the purposes of REIT taxation. If groundswell grows for REIT reform because of bad optics, the law could change in ways that accomplish little or no meaningful reform and changes could inflict considerable economic harm. Any change to the law could restrict the ability of small investors investing in diversified pools of real estate, could slow the flow of capital to real estate markets, and could impair real estate markets and the general economy. Thus, bad optics could have serious negative effects, and academics and others should take seriously the obligation of studying issues related to REIT taxation and helping others better understand those issues.

IV. REFORM ALTERNATIVES

The analysis of what is the matter with REITs reveals four ostensible problems with REIT taxation: (1) REITs appear to have a negative effect on tax revenue, (2) REITs create inequity, (3) the current REIT regime fosters inefficient transactions and structures, and (4) REIT taxation looks bad to a lay audience when compared to corporate taxation. That analysis reveals that bad optics appears to be the driving force behind REIT reform discussions, so lawmakers should proceed with care when considering REIT reform. In fact, analyses of REIT reform consider the stated purposes for enacting the REIT regime: (1) to provide greater investment opportunities for small investors and (2) to channel capital to real estate markets.⁴³¹ It should also

430. See Borden, *Rethinking the Effect*, *supra* note 27, at 599–611 (estimating the tax-revenue effect of investors forming REITs instead of partnerships).

431. See *supra* notes 67–68 and accompanying text. Some commentators also claim that preserving the corporate tax base is one purpose of the REIT regime. See, e.g., Johnson, *Reinvigorating the REIT's Neutrality*, *supra* note 27, at 90–91.

consider other benefits that derive from REIT taxation, including better monitoring opportunities⁴³² and more stable real estate markets.⁴³³ If a reform proposal does not better facilitate those purposes, perhaps it should be scrapped.

Three possible REIT reform alternatives come to mind as a result of considering the ostensible problems of REIT taxation. First, lawmakers could disregard reform and maintain status quo. Second, reform could eliminate the preferential tax treatment that REITs afford real estate by either expanding or contracting the entity-level tax, or by modifying the REIT rules. Tax law could also eliminate preferential tax treatment by modifying the rules governing tax-exempt and foreign investors. Third, reform could consider removing the formalistic aspect of the current system and make preferential tax treatment for real estate easier to obtain. The following discussion considers each alternative in turn.

A. *Maintain Status Quo*

Amidst the discussion of REIT reform, one alternative is to maintain status quo, even though the status quo is perhaps illusory. Based upon the trajectory of REIT legislation, if lawmakers do nothing to restrict REIT taxation, over time it will most likely continue to evolve in ways that make passive real estate ownership more convenient. Consequently, maintaining status quo undoubtedly means continued expansion of the REIT regime along the trajectory of the past fifty-plus years. The tax-revenue effect of REIT taxation is nominal,⁴³⁴ but maintaining the status quo would not decrease that nominal effect, either from corporate- or partnership-income-tax-base erosion. Favorableness of other tax-policy objectives nonetheless bode well for maintaining the status quo.

This Article recounts the history of REITs and explains several developments that have occurred since Congress enacted the original REIT regime in 1960;⁴³⁵ the discussion is actually light on the technical details.⁴³⁶ REIT taxation therefore comes across as complex with numerous technical requirements and voluminous rulings and regulations that interpret those requirements. That perceived complexity may raise the concern

432. See *supra* text accompanying notes 421–24.

433. See *supra* text accompanying notes 448–50.

434. See J. COMM., ESTIMATED REVENUE EFFECTS, *supra* note 353.

435. See *supra* Part II.B–C.

436. The technical details are evidenced in part by the numerous pages of tax code and regulations that this Article does not cover.

that the current state of the law undermines the original purpose of making real-estate-portfolio ownership available to a broader cross section of the population. Complexity of the tax system in general, and the place of REITs in that system, also increase the difficulty of assessing the revenue effects of REIT taxation,⁴³⁷ and continued development in this area could add more complexity. Nonetheless, those who work closely with the REIT rules undoubtedly applaud the developments that have occurred over the years because the current rules provide greater certainty about the types of services that REITs can provide and therefore reduce the cost of complying with the rules and managing real estate.⁴³⁸

The status quo also does not, however, eliminate the inequity that exists between REITs and corporations on one hand and partnerships on the other, but that inequity conundrum would be difficult to solve.⁴³⁹ The status quo also does not resolve the inefficiencies that result from the structures currently in use,⁴⁴⁰ but it does preserve the efficiencies that stem from the current system.⁴⁴¹ Maintaining status quo will not improve the bad optics of the current system, but perhaps a greater focus on REIT taxation by more policy analysts will help dispel some of the misunderstanding related to REIT taxation. Despite its shortcomings, the status quo should not give way to a different system unless the different system proves to be better. The status quo incorporates the experience of more than fifty years of practice that make the rules more practical and help to make ownership of real estate available to even more investors.

Information about the financial performance of REITs suggests that more capital is flowing to the REIT markets as a result of several changes to the law over the past half-century.⁴⁴² Although one might expect the capital to flow disproportionately to a relatively small group of real estate professionals and former

437. See, e.g., Boos, *supra* note 28, at 1289 ("These REIT conversions provide significant tax benefits for the eligible businesses; however, even bigger consequences may stem from the grant rate for REIT conversions in private letter rulings."). But see Borden, *Rethinking the Effect*, *supra* note 27, at 592–99 (presenting a dynamic analysis of the tax-revenue effect of REIT spinoffs and conversions, which shows that the tax-revenue effect is nominal).

438. See *supra* Part II.C.2, 6. (discussing the changes to rules governing services that REITs may provide).

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

440. See *supra* Part III.C.1.

441. See *supra* Part III.C.2.

442. See *supra* text accompanying notes 6–15.

property owners, empirical studies of REIT IPOs suggest that REITs are primarily funded using proceeds generated from IPOs, suggesting the money does not disproportionately go to preexisting REIT owners.⁴⁴³ The REIT industry touts the benefits it provides to the economy including job creation and investment opportunities for beneficiaries, such as teachers and police officers, of pension plans that invest in REITs.⁴⁴⁴ If these claims are valid, they could be lost if Congress eliminated REITs and no other ownership structure could sufficiently fill the void that would be left by the elimination of REITs.⁴⁴⁵

Analysts are not certain that the price performance of REIT stock correlates to the performance of real estate.⁴⁴⁶ In fact, as REITs provide more services and as institutional ownership of REITs increase, they may perform more like non-REIT stock than like real estate,⁴⁴⁷ so REIT performance may not be indicative of the performance of the real estate that REITs own. Nonetheless, one study suggests that the information provided by REITs, the attention they receive from analysts, and institutional investment in REITs helps stabilize real estate markets, preventing the oversupply of commercial real estate.⁴⁴⁸ The study concludes that “the commercial property supply response in periods of high asset price returns was increasingly moderated as the share of assets

443. See, e.g., Chen, Fok & Lu, *supra* note 419, at 365, 376 (finding that REIT IPO lockup agreements tend to cover longer periods than traditional IPO lockup agreements and most insiders tend to retain their REIT shares following the unlock date); Dolvin & Pyles, *supra* note 217, at 99–100 (finding that even though the retention rate of preexisting REIT owners is lower than the retention rate of shareholders in traditional IPOs, preexisting ownership as a percentage of total REIT IPO issuance is much smaller than the percentage for nontraditional IPOs).

444. See *Economic Impact of REITs: REITs by the Numbers*, *supra* note 361.

445. If REITs did not hold real estate, perhaps the real estate would be owned and operated by other investors and create the same benefits that REITs currently create. More study is needed to determine whether REIT taxation creates jobs that would not otherwise exist in the absence of a REIT regime.

446. See CHAN, ERICKSON & WANG, *supra* note 13, at 197–203 (reviewing the studies that consider whether REIT stock performance more closely correlates to the general stock market or to real estate, and providing references to studies that support both conclusions).

447. See *supra* text accompanying notes 421–24.

448. See FRANK PACKER, TIMOTHY RIDDIOUGH & JIMMY SHEK, CAN SECURITIZATION WORK? LESSONS FROM THE U.S. REIT MARKET 8–10 (2013), https://www.reit.com/sites/default/files/media/PDFs/Can%20Securitization%20Work_001.pdf; Packer, Riddiough & Shek, *supra* note 26, at 136–42. This work has been touted by the REIT industry as making “it clear that REITs provide real benefits for the broader commercial real estate industry, for investors and for our nation’s economy.” See Ronald L. Havner, *Beneficial Influence of REITs*, REIT: REAL EST. INV. TODAY (Mar.–Apr. 2014), <https://www.reit.com/node/16799/beneficial-influence-reits>.

held by REITs increased.”⁴⁴⁹ It also finds claims that REITs, “by moderating construction boom and bust tendencies, can generate positive spillover benefits to the economy at large.”⁴⁵⁰ This study is fairly recent, but, if it withstands scrutiny, it suggests that REIT taxation provides significant non-tax benefits to the economy. Those non-tax benefits should offset the estimated \$2 billion of tax-revenue loss REIT taxation may cause.⁴⁵¹ Consequently, even though REIT taxation may cause some tax-revenue loss, the benefit it provides offsets that cost.

Even though maintaining status quo does not accomplish all of the tax-policy goals discussed above, it accomplishes Congress’s goals in enacting REIT taxation, it has inertia and familiarity on its side, and it provides non-tax economic benefits to the economy. Consequently, its benefits offset its deficiencies.

B. Eliminate Preferential Treatment

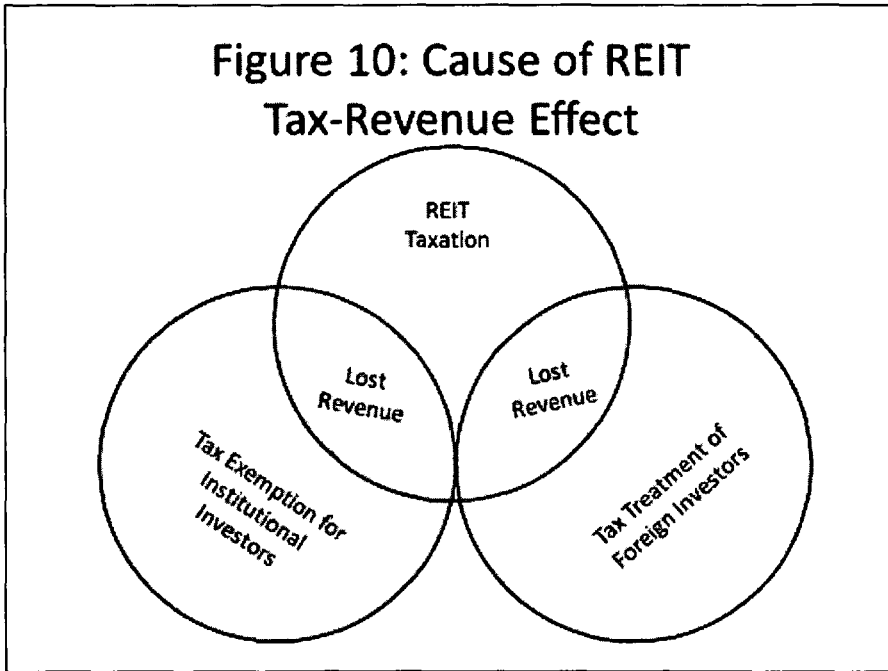
Congress could eliminate some or all of the deficiencies of REIT taxation by repealing or narrowing REIT taxation, changing the tax treatment of REIT investors, changing the scope of entity-level taxation, or some combination of these actions. The tax-revenue effect resulting from REIT taxation derives most significantly from the overlap of three tax policies—(1) the preferential tax treatment that REITs afford real estate assets compared to assets of regular corporations, (2) the preferential tax treatment afforded to tax-exempt investors, and (3) the preferential treaty rates available to foreign investors in REITs (see Figure 10).⁴⁵² Partnership and corporate tax policy also affect the inequity, inefficiencies, and bad optics of REIT taxation.

449. See Packer, Riddiough & Shek, *supra* note 26, at 141.

450. See *id.* at 142.

451. See *supra* text accompanying notes 349–53 (summarizing estimates of the tax-revenue effect of REIT taxation).

452. See Borden, *Rethinking the Effect*, *supra* note 27, at 566–83, 592–613 (illustrating that the various tax policies affect the tax-revenue impact of REIT taxation and presenting a mathematical model that suggests that variables other than corporate-tax-base erosion contribute most significantly to lost tax revenue that may result from REIT taxation).



To eliminate or significantly reduce perceived problems caused by REIT taxation, lawmakers are faced with the task of making changes that would affect real estate tax policy, corporate or partnership tax policy, retirement-plan tax policy, international tax policy, or all. Such changes could include reforming REIT taxation by scaling it back in one of multiple possible ways, altering rules governing retirement savings and tax-exempt and foreign investments, eliminating double taxation, or expanding entity-level taxation. The following analysis considers each alternative in turn.

1. *Scale Back REIT Taxation.* Reform could scale back REIT taxation in a number of ways, including completely repealing the REIT regime, prohibiting future tax-free REIT spinoffs and conversions, narrowing the definition of real property, and restricting the types of services a REIT can perform.⁴⁵³ As discussed above, REIT taxation causes nominal tax-revenue

453. Commentators have recommended various types of reform. See, e.g., Boos, *supra* note 28, at 1298–1302 (recommending all three types of reform); Taylor, *Comments on Camp Proposal*, *supra* note 28, at 244–45 (recommending restricting the activities that taxable REIT subsidiaries may provide, amending the earnings stripping rules that apply to debt of a taxable REIT subsidiary, and suggesting that the definition of real property should not include goodwill of an operating business).

losses,⁴⁵⁴ so its repeal would not significantly increase tax revenue. Instead, it could have the unfortunate consequence of driving capital from U.S. real estate markets and destabilizing the markets. Repeal of REIT taxation would also limit the portion of the population that can invest in real estate. Consequently, complete repeal would eliminate any benefits that REIT taxation provides to small investors, the real estate market, and the general economy.⁴⁵⁵ The cost of such a loss could exceed the nominal potential increase in tax revenue collected in the absence of REIT taxation.⁴⁵⁶ Repeal of REIT taxation would not solve the inequity problem because tax law would still treat regular corporations, partnerships, and RICs differently. It would solve the inefficiencies related to REIT ownership of real estate, but it would eliminate the efficiency benefits of REIT taxation.⁴⁵⁷ Of course, if REIT taxation did not exist, it would cease to be an eyesore to those who criticize it. That would be a small gain at a significant cost.

Scaling back other aspects of the REIT regime would probably nominally affect tax revenue, if at all, but such changes could increase complexity and inefficiency. For instance, if Congress were to restrict the type of services a REIT can provide directly or through a taxable REIT subsidiary, REITs would have to create more complicated separation arrangements, which would have to include independent contractors. Such arrangements add costs,⁴⁵⁸ so they would increase inefficiencies. Restrictions on the types of services that a REIT can provide would not improve equity because REIT income would still be treated differently from income of regular corporations, and REITs would be even more restricted than partnerships.⁴⁵⁹ More restrictive rules would also make REITs less attractive and drive capital from the real estate markets, and a decline in real estate investment would curtail the benefits that currently stem from REIT taxation. Consequently, restricting the types of services that REITs may provide would not appear to further any significant tax-policy objective.

Some commentators are concerned that REITs provide advantageous tax treatment to too broad a class of real estate, and

454. See *supra* text accompanying notes 349–53.

455. See *supra* text accompanying notes 446–51.

456. See *supra* text accompanying notes 349–53 (providing that the total tax-revenue effect of REIT taxation is approximately \$2 billion).

457. See *supra* Part III.C.

458. See *supra* text accompanying note 182.

459. See *supra* Part III.B.1 (describing the equity conundrum that exists under the current tax system).

recommend narrowing the class of assets that qualify for REIT taxation.⁴⁶⁰ Such a change in the law would accomplish little in terms of tax policy objectives. The different tax treatment afforded REITs and regular corporations would remain the same, but the different tax treatment afforded REITs and partnerships would be amplified because REITs would not be able to hold property that partnerships can hold. Consequently, such a change would not improve equity. Such a change would do little to improve efficiency because REITs would continue to use the current structures to hold the types of assets that they hold. The change would negatively affect the transparency and other benefits that result from separate operations and ownership of certain types of real estate because such property would no longer qualify for REIT taxation. Furthermore, the types of assets that were not held by REITs at the time Congress enacted the first REIT regime are a fraction of the total property held by REITs, so changing the law to restrict the types of assets that REITs hold would not significantly increase tax revenues. Perhaps the strongest argument in favor of changing the law to restrict the types of assets that a REIT can hold is that doing so would improve optics. That should not, however, be a motivation for changing the law.

Another reform alternative is to prohibit tax-free REIT spinoffs and conversions.⁴⁶¹ As explained above, prohibiting tax-free REIT spinoffs would not improve equity.⁴⁶² Because the spinoff rules only apply to corporations,⁴⁶³ an operating corporation cannot spin off a publicly traded partnership tax-free. Consequently, prohibiting tax-free REIT spinoffs would make REITs and publicly traded partnerships similar in that respect. In fact, prohibiting REIT spinoffs would amplify the disparate treatment between regular corporations that hold real estate and spun-off REITs and newly formed arrangements that separate operations and real estate ownership from the outset.⁴⁶⁴ As discussed above, the structures that result from REIT spinoffs impair certain types of efficiencies and improve other types.⁴⁶⁵ The

460. See, e.g., Boos, *supra* note 28, at 1299–1300 (discussing reform alternatives for narrowing the REIT definition of real property).

461. See Camp Proposal, *supra* note 2, §§ 3631, 3647.

462. See *supra* Part III.B.3.

463. See I.R.C. § 355(a) (2012) (requiring a dividing corporation to distribute stock or securities to its shareholders or security holders).

464. See *supra* Part III.B.3.

465. See *supra* text accompanying note 400 (recognizing that separating operations and ownership can increase agency costs); *supra* notes 178–82 and accompanying text (presenting industry complaints that the use of independent contractors creates agency

tax-revenue effect of REIT spinoffs is miniscule,⁴⁶⁶ so curtailing them would not materially affect tax revenues. In fact, eliminating favorable treatment afforded to REITs and REIT spinoffs would not eliminate inequity, but only redraw the boundary lines at a new point that would have its own inequities, and it would not materially improve efficiency or tax revenues. As with other reform alternatives, such a change would appear to do nothing more than improve optics. Consequently, such changes do not enjoy any significant policy support.

A discussion of scaling back REIT taxation requires considering whether the nature of real estate warrants granting it favorable tax treatment. The fundamental attributes of real estate, i.e., land and permanent structures on the land, is that it is immovable.⁴⁶⁷ Traditionally, real estate assets remain in use longer than other types of assets. For example, buildings remain useful and valuable for decades and many can retain their usefulness and value for centuries. By contrast, personal property generally does not remain useful for such long periods. Personal property, such as manufacturing equipment, is apt to become obsolete much faster than a building. Even personal property such as rolling railroad stock or large construction equipment generally does not remain useful as long as buildings do. Because of its inherent permanency and uniqueness, real estate may play a more critical role in the stability of the economy and therefore should receive preferential tax treatment for that reason. Nonetheless, the last decade suggests that unregulated channeling of capital to some real estate markets can cause financial havoc, as is evident from the collapse of mortgage-backed securities.⁴⁶⁸

Although structured real estate finance appears to be a proximate cause of the 2008 financial crisis, much of the problems that stem from the crisis are attributable to wrongdoing by loan originators and promoters of mortgage-backed securities.⁴⁶⁹ For years prior to the crash, structured finance appeared to serve its purpose of bringing additional capital to the residential market

costs); see also Decker, Kaplan & Ponda, *supra* note 28, at 414–22 (recounting the development of rules governing services that REITs may provide).

466. See Borden, *Rethinking the Effect*, *supra* note 27, at 599 (estimating the tax-revenue effect of REIT spinoffs to be around \$250 million); see also Nugent, *supra* note 28, at 1529–30 (discussing offsetting factors to the effect of REIT spinoffs on tax-revenue).

467. See 2 WILLIAM BLACKSTONE, COMMENTARIES *16.

468. See Borden & Reiss, *supra* note 118, at 680–91 (discussing the bad behavior that resulted from the demand for mortgage-backed securities).

469. See FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, at xxii–xxiv, 109–11, 127–44 (2011); Borden & Reiss, *supra* note 118, at 680–91.

and making capital more affordable.⁴⁷⁰ The lack of regulation, however, enables some bad actors to have an outsized influence on the market and cause significant harm.⁴⁷¹ A well-regulated real estate finance market, which could include REITs, would appear to be the basis for a strong economy.

The legislative history of the original REIT legislation contains very little about why real estate should receive preferential tax treatment. The earliest proponents of REIT taxation wisely focused on obtaining treatment for real estate that was similar to treatment provided to mutual funds, and argued that preferential real estate treatment would help channel capital to real estate markets and strengthen the economy.⁴⁷² In later years, proponents of REIT taxation argued that creating greater opportunities for pension funds to invest in REITs would provide much needed capital to the real estate markets.⁴⁷³ They argued that the lack of capital depressed the real estate market, which has a “negative multiplier effect on our economy.”⁴⁷⁴ According to that argument, because real estate is used as collateral for most loans, “[w]hen land and property values decline, banks are forced to call in loans or require more cash, forcing some businesses into bankruptcy and drying up credit for others.”⁴⁷⁵ Finally, a significant portion of local-government revenues come from real estate property taxes, so “[d]eclining land and property values invariably mean cuts in vital public services.”⁴⁷⁶

REIT critics may look to studies from other areas of the law to argue against the preferential treatment REIT taxation provides to real estate and to argue for its partial or total repeal. Tax law grants preferential treatment for homeowners in the form of mortgage interest deductions,⁴⁷⁷ property tax deductions,⁴⁷⁸ and

470. See Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765, 768–97, 802–03 (2005) (describing the history of the mortgage-backed securities industry and its purpose to bring more capital to the residential real estate market, and concluding that “the availability of affordable mortgage money and assembly-line lending practices that are the direct result of the secondary market propel an unprecedented deluge of conveyances and refinances”).

471. See *supra* note 469 and accompanying text.

472. See *supra* text accompanying notes 65–68.

473. See 139 CONG. REC. 19356 (Aug. 5, 1993) (statement of Jim Moran).

474. See *id.*

475. See *id.*

476. See *id.*

477. See I.R.C. § 163(a), (h)(2)(D) (2012).

478. See § 164(a)(2).

exclusion of gain on the sale of a principal residence.⁴⁷⁹ Such favorable tax treatment has been the object of serious criticism, with critics claiming that the preferential treatment does not benefit homeowners. Instead, it encourages undesirable consumer borrowing against home equity with the value of the incentives capitalized into the price of the property.⁴⁸⁰ Some research suggests that home ownership is lower in jurisdictions that provide higher tax subsidies,⁴⁸¹ suggesting that tax incentives alone do not influence home ownership. Because the home-mortgage interest deduction distorts behavior and creates a false baseline for home prices, perhaps its only saving grace is a short-term benefit it provides to the housing industry.⁴⁸²

The criticisms of the tax incentives related to home ownership do not appear to apply to REIT taxation. REIT taxation should discourage irresponsible borrowing because tax law treats REIT debt the same way it treats REIT equity, allowing a deduction for both interest and dividends.⁴⁸³ The median debt ratio of REITs in the S&P 500 index is more than twice as high as the median debt

479. See § 121(a).

480. See, e.g., Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TULANE L. REV. 373, 414–16 (1994) (suggesting that the home mortgage interest deduction encourages home equity borrowing for consumption); Roberta Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L.J. 1347, 1359, 1368 (2000) (arguing that the home mortgage interest deduction only benefits certain types of buyers and that it contributes to urban sprawl); Rebecca N. Morrow, *Billions of Dollars Spent Inflating the Housing Bubble: How and Why the Mortgage Interest Deduction Failed*, 17 FORDHAM J. CORP. & FIN. L. 751 (2012) (arguing that the home mortgage interest deduction inflates home prices and encourages borrowing against home equity); Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROBS. 233, 236, 240–43 (2010) (revealing that no reason was presented for the home interest deduction when enacted as part of the 1913 income tax, and that all policy justifications were presented after the enactment, suggesting that the provision was not enacted to advance policy purposes).

481. See Edward L. Glaeser & Jesse M. Shapiro, *The Benefits of Home Mortgage Interest Deduction* 39–40 (Nat'l Bureau of Econ. Research, Working Paper No. 9284, 2002), <http://www.nber.org/papers/w9284.pdf>. The extent to which the tax benefits affect value is uncertain, but has been estimated to be as much as 7%. See James Poterba & Todd Sinai, *Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income* (Jan. 5, 2008), <http://economics.mit.edu/files/2525>.

482. See Dennis J. Ventry Jr., *Misinformed and Misled About the Benefits of the Mortgage Interest Deduction*, 16 CITYSCAPE: J. POL'Y DEV. & RES., no. 1, 2014, at 219, 220–21 (summarizing and challenging arguments for the home mortgage interest deduction); Dennis J. Ventry, *The Fake Third Rail of Tax Reform*, 135 TAX NOTES 181, 182–83, 193–96 (Apr. 9, 2012) (pointing out the inadequacies of the mortgage interest deduction and suggesting reform alternatives).

483. See I.R.C. § 163(a) (2012) (allowing a deduction for interest); § 857(b)(2)(B) (granting REITs a deduction for dividends paid).

ratio of non-financial members of the S&P 500,⁴⁸⁴ which suggests that REITs are more prone to borrowing than other types of publicly traded regular corporations. The explanation for this practice may be that the REIT dividend payout requirement makes debt less expensive than equity for REITs, so they take on more debt than regular corporations.⁴⁸⁵ A more relevant barometer of whether REITs borrow responsibly may be a comparison of REITs to other owners of real estate. REIT real estate leverage is much lower than non-REIT real estate leverage.⁴⁸⁶ Thus, REITs, with their lower leverage, can help stabilize real estate markets.

Finally, partial or complete repeal of REIT taxation could also affect investors. Because Congress enacted REIT taxation to help more investors have an opportunity to invest in real estate portfolios,⁴⁸⁷ the analysis should consider whether REIT taxation is accomplishing this purpose. The study of mutual fund ownership is comprehensive, so information about mutual fund ownership may shed some light on what part of the population is likely to hold REIT stock. Approximately 46% of the population holds mutual funds.⁴⁸⁸ Most of those investors are in the wealthiest half of the population, but ownership of mutual funds, as a percentage of income cohort, is greatest among households that have between \$100,000 and \$199,999 of income.⁴⁸⁹ This suggests that a similar cross section of the population could or does own REIT stock directly or through a REIT mutual fund. Furthermore, a significant portion of the population holds REIT stock indirectly through their retirement fund holdings with

484. See MIKE KIRBY, GREEN STREET ADVISORS, CAPITAL STRUCTURE IN THE REIT SECTOR 4 (2009), <https://www.greenstreetadvisors.com/pdf/insights/capitalstructure/0709.pdf> (reporting that the median leverage ratio (net liabilities ÷ total market capitalization) for non-financial companies was 21% and was 54% for REITs); see also Feng, Gosh & Sirmans, *supra* note 245, at 90 (reporting that on average REITs maintain a debt ratio of above 50% while non-REIT firms have maintained a ratio below 50%, and a REIT's debt ratio grows and stabilizes around 65% ten years after an IPO).

485. See Feng, Gosh & Sirmans, *supra* note 245, at 90–91.

486. Ponda Interview, *supra* note 214. Bank lending standards typically hold banks to prudent underwriting standards that include loan-to-value limits. See 12 C.F.R. § 365.2(b)(2)(ii) (2015). The FDIC generally requires that loan-to-value limits should not exceed the following amounts: 65% for raw land, 75% for land development, 80% for construction of commercial, multifamily, and nonresidential property, 85% for 1- to 4-family residential, and 85% for improved property. 12 C.F.R. pt. 365, subpt. A, app. A (2015). Undoubtedly, many property owners and lenders lend up those limits, which would mean that private real estate could be leveraged to levels that significantly differ from the REIT debt ratios.

487. See *supra* note 67.

488. See *supra* note 60.

489. See INV. CO. INST., 2014 INVESTMENT COMPANY FACT BOOK 106 (54th ed.), http://www.ici.org/pdf/2014_factbook.pdf.

institutional investors.⁴⁹⁰ Even though Congress probably did not anticipate the scope of mutual funds and retirement plans that exist today, REIT taxation provides the opportunity for a broad cross section of the population to participate in a portfolio of real estate through retirement plans or mutual funds. Although that is not the explicitly stated purpose of REIT taxation, perhaps it is a desirable unintended consequence that REIT reform would eliminate.

Although there are calls for REIT reform, the proposals do not withstand careful tax-policy analysis. Consequently, repealing or scaling back REIT taxation does not enjoy tax-policy support and appears to be the product of misinformed perception of REIT taxation.

2. *Alter Retirement-Savings and Foreign-Investment Tax Policy.* Instead of reforming REIT taxation, the government could curtail the tax-revenue effect of REIT taxation by changing the rules that govern the taxation of REIT investors. A significant portion of lost tax revenue attributed to REIT taxation actually comes as a result of tax-exempt and foreign investors holding REIT stock.⁴⁹¹ Modifying the rules governing the taxation of retirement plans, other tax-exempt entities, and foreign investors could therefore raise tax revenue. Of course, any effort to alter the overall tax exemption for retirement-savings funds would face almost impossible odds. Other institutional investors, such as university endowments, may be more vulnerable to attack,⁴⁹² but even changing the tax treatment of that type of entity would appear to be a longshot.⁴⁹³ The only hope for reform in this area

490. See *supra* note 444.

491. See Borden, *Rethinking the Effect*, *supra* note 27, at 579–83, 592–613; see also Alan I. Appel et al., *FIRPTA, Section 892 and REITS*, 2015 A.B.A. TAX SEC.: REAL EST. COMM., May 8, 2015, at 35–40, <http://apps.americanbar.org/dch/thedl.cfm?file name=/TX334800/newsletterpubs/15may-re-firptasection892andreits.pdf> (describing REIT tax advantages available to foreign sovereigns).

492. See, e.g., Annie Lowry, *Take Away Harvard's Nonprofit Status*, N.Y. MAG. (Sept. 9, 2014), <http://nymag.com/daily/intelligencer/2014/09/take-away-harvards-nonprofit-status.html> (arguing that Harvard's endowment should not be exempt from tax); Peter Schworm & Matt Viser, *Lawmakers Target \$1B Endowments*, BOSTON (May 9, 2009), http://www.boston.com/news/local/articles/2008/05/08/lawmakers_target_1b_endowments/?page=full (reporting that Massachusetts lawmakers asked finance officials to study a plan that would impose a 2.5% annual assessment on colleges with endowments over \$1 billion).

493. Despite the calls for taxation of large university endowments, apparently no legislative action has occurred to tax them. See Jeffrey J. Selingo, *Are Harvard, Yale, and Stanford Really Public Universities?*, WASH. POST: GRADE POINT (Apr. 6, 2015), <http://www.washingtonpost.com/news/grade-point/wp/2015/04/06/are-harvard-yale-and-stanford-really-public-universities/>.

would therefore be some type of carve-out that would subject some portion of REIT distributions to such entities to taxation. For example, the law could require REITs to pay corporate tax on amounts distributed to tax-exempt and foreign investors. Such a change could reduce the negative tax-revenue effect of REIT taxation, but it would not eliminate inequity, inefficiency, or bad optics.

Subjecting REIT income received by retirement plans to income tax would not eliminate inequity because REITs would still be taxed differently from corporations. Also, subjecting REIT income to tax would treat REIT income differently from income received from direct ownership in real estate. Taxing REIT income at the retirement fund level would not change the inefficiency described above⁴⁹⁴ because REITs would still have to separate operations from ownership to receive preferential treatment for income not distributed to tax-exempts and would need one of the inefficient structures to do so. The bad optics would continue because REITs would still appear to erode the corporate tax base.

Subjecting tax-exempt and foreign investors' REIT income to tax could, however, significantly affect small investors' ability to benefit from investments in real estate portfolios. Such a change could seriously impede the flow of capital to real estate markets, which would reduce or eliminate the monitoring role that institutional investors play in REITs. Consequently, small investors would lose the benefits obtained directly and indirectly through such investment.⁴⁹⁵ If institutional investors lost the tax benefit of investing in REITs, they would undoubtedly reduce their REIT investments, the flow of capital to real estate markets would decrease, and the stability of commercial real estate could suffer. Consequently, in addition to being politically infeasible, the gains to be had from changing rules governing institutional investment in REITs would not outweigh the costs of changing the current rules.

3. *Eliminate Double Tax Altogether.* Another way to eliminate the disparity between the taxation of REIT income and the income of regular corporations is to simply eliminate the double tax on corporate income. Congress could eliminate the double tax by either eliminating the entity tax altogether or by

494. See *supra* text accompanying notes 394–411.

495. See *supra* text accompanying notes 421–24, 446–51 (discussing the benefits that derive from institutional investment in REITs, which inure to others who also invest in REITs).

adopting a method for integrating corporate and individual tax rates. The validity of the corporate tax has been debated for decades from various perspectives.⁴⁹⁶ This Article does not attempt to enter that discussion or weigh in on it from a general perspective. Instead, the Article considers elimination of the double tax that results from the current U.S. corporate tax regime merely as a point of reference for correcting the inequity that results from taxing REIT and corporate income differently. If tax law eliminated the double tax, the incentive to avoid the double tax would also disappear, and without such incentive, parties would be less likely to form flow-through and conduit entities such as REITs.⁴⁹⁷ Nonetheless, eliminating the entity-level tax would eliminate all corporate tax revenue. An integration system would eliminate the double tax on income distributed to taxable shareholders. Either of those changes could have a negative, although perhaps not significant, effect on tax revenues.⁴⁹⁸

To the extent that eliminating the double tax on corporate income would negatively affect tax revenue, Congress could change other parts of the law to offset the lost tax revenues. Congress could, for instance, increase the tax on income from flow-through and conduit entities or subject greater portions of the income of tax-exempt entities to tax.⁴⁹⁹ Parties who are allocated income from flow-through and conduit entities could, therefore, see an increase in tax rates, and they would most likely oppose the elimination of the entity- and shareholder-level tax on corporate

496. See, e.g., Yariv Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, 2008 MICH. ST. L. REV. 591, 592–98 (2008) (summarizing some of the arguments in favor of the entity-level corporate tax).

497. See Bradley T. Borden, *Tax Aspects of Partnerships, LLCs, and Alternative Forms of Business Organizations*, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCs AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 147, 160–61 (Robert W. Hillman & Mark J. Lowenstein eds., 2015) (providing that Canadian tax practitioners believe that the Canadian integrated corporate tax system disincentivizes the use of flow-through tax entities, so Canada flow-through tax regimes have not developed to the extent of U.S. flow-through tax regimes). Nonetheless, Canada and other countries that have integrated individual and corporate tax systems often have a REIT regime. See Canada Income Tax Act § 122.1(1) (R.S.C., 1985, c. 1 (5th Supp.)); Andrew H. Kingissepp, *Canada: New Tax on Income Trusts; Economic Update*, J. INT'L TAX'N, Mar. 2007, at 22, 25–27 Daly, *supra* note 27, at 840, 843, 847–49, 855–58 (discussing REIT regimes in the United Kingdom and Germany). The existence of REITs in such regimes may suggest that REITs provide non-tax advantages that attract investors.

498. See Borden, *Rethinking the Effect*, *supra* note 27, at 612–13 (demonstrating that the tax revenue generated from REIT income is not much less than the tax revenue that the same income would generate if it were earned by regular corporations).

499. See Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1335–36 (2013) (recognizing that revenue lost from repealing the corporate tax would have to be offset by increases elsewhere).

income.⁵⁰⁰ If Congress were to eliminate the double tax on corporate income, corporate income that flows through to shareholders might become subject to the same tax to which REITs are currently subject. That may result in investments shifting away from REITs, and other flow-through entities, to corporations. Thus, REITs, REIT investors, members of partnerships, and their advisors would most likely oppose eliminating the double tax.

Eliminating the double tax on corporate income would satisfy other tax policy objectives related to REIT taxation. Eliminating the corporate double tax would promote equity because the owners of entities would not be subject to the double tax, regardless of form, so REIT income, income of regular corporations, and income from partnerships would be taxed the same, not taking into account the taxation of investors. Elimination of the corporate tax would also promote efficiency because property owners would not have to use cumbersome ownership structures to divide operations from real estate ownership. Instead, all income would be subject to a single level of tax. The problem of bad optics should also disappear with the elimination of the double tax on corporate income. The downside of such reform is that single-entity ownership of operations and real estate eliminates transparency that results from having multiple publicly traded entities serving different functions,⁵⁰¹ so elimination of the double tax on corporate income would not enhance efficiency perfectly.

Eliminating the double tax should not affect small investors' ability to invest in REITs or other arrangements that hold real estate. If Congress were to eliminate the double tax, small investors could invest in real estate through corporations or REITs, both of which could hold diversified real estate portfolios and be subject to the same tax. The single level of tax would also put REITs on a footing similar to that of partnerships, so small investors could have opportunities through REITs that are available to wealthy partnership investors. The elimination of double tax could, however, negatively affect the flow of capital to real estate markets. Without the comparative advantage that REITs currently enjoy, REITs may be unable to attract the same level of investment because the investment choice will become tax

500. See, e.g., Richard Rubin, *Bid to Lower Corporate Tax Rate Stirs Backlash from Business*, BLOOMBERG (Jan. 13, 2015), <http://www.bloomberg.com/news/2015-01-13/bid-to-lower-corporate-tax-rate-stirs-backlash-from-businesses.html> (discussing opposition from owners of flow-through businesses to legislation that would reduce the corporate tax rate and curb other business tax breaks to pay for the rate reduction).

501. See *supra* text accompanying notes 421–24.

neutral.⁵⁰² Thus, the elimination of the double tax satisfies most of the REIT policy criteria, but it may negatively affect the flow of capital to real estate markets, which would most likely negatively affect the stability of the real estate markets.

4. *Expand Entity-Level Taxation.* Another way to enhance equity between corporations, REITs, and partnerships is to expand entity-level taxation to cover REITs and partnerships.⁵⁰³ A broader entity-level tax regime could increase tax revenue, depending upon how the law would affect owner-level taxation. The broader entity-level tax would enhance equity because all forms of business entities would be subject to the tax, and it would improve efficiency because property owners would not be able to avoid the entity-level tax with complex ownership structures. The elimination of such structures would also cure the bad optics in the current system, because corporations would not spin off real estate to erode the corporate tax base. If the entity-level tax applied to direct ownership in real estate, small investors who owned property through a corporation would be treated the same as investors who could invest directly in real estate. If the comprehensive entity-level tax did not have a distribution requirement for corporations that own real estate, it would most likely disrupt the flow of capital to real estate markets, which benefit under the current REIT rules because investors appear to prefer investments that make regular distributions.⁵⁰⁴

This discussion suggests that Congress could enhance equity, efficiency, and optics by creating a tax system that treated all entities the same. Such a system would not deprive small investors from the investment opportunities afforded to wealthy investors. It would, however, most likely divert capital away from real estate markets. However, perhaps the unique attributes of real estate

502. Notice, however, that following the Jobs and Growth Tax Relief Reconciliation Act of 2003, which lowered the corporate dividend rate to 15% making the corporate double tax less onerous, *see* P.L. 108-27, § 302(e)(5), (6), REIT market capitalization of REITs continued to grow significantly. *See supra* Figure 1. This suggests that anything less than complete repeal of the double tax and the REIT distribution requirement may not stem the flow of capital to REITs, but the complete repeal of the corporate tax would tax the income of regular corporations and REITs identically.

503. *See, e.g.,* Martin J. McMahon, Jr., *Rethinking Taxation of Privately Held Businesses* (July 7, 2015) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2500476 (proposing an entity-level tax on all business entities, which presumably could include REITs).

504. *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").

warrant treating entities that own real estate differently from other ownerships structures.⁵⁰⁵ If changing the law to advance principles of equity and efficiency has a significantly negative effect on the economy, the traditional tax policy objectives should perhaps yield to the economic benefits conferred by the current system.

C. *Bifurcate Income*

All of the reform alternatives discussed to this point suffer from some policy or other defect, and the prospect of significantly changing REIT taxation or repealing or expanding entity-level tax is probably remote. Instead of focusing on entity structures, perhaps the law should embrace a system that exempts passive-type income from entity-level tax and eliminate inequity and inefficiency with a system that bifurcates income (i.e., separates passive-type income from other income) within single entities.⁵⁰⁶ To separate real-estate income from operating income under the current system, operating corporations spin off their real estate assets or convert to REITs with taxable REIT subsidiaries.⁵⁰⁷ Under the current system, REITs form taxable REIT subsidiaries to provide noncustomary tenant services to the users of their property.⁵⁰⁸ These structures often separate operations from ownership in form only, with control of both operations and ownership residing in common owners.⁵⁰⁹

The Windstream spinoff provides a framework for considering how a bifurcation approach would differ from the current system. To separate the passive real estate income from its operations and ensure that two types of income were taxed differently, Windstream had to transfer the real estate to a separate publicly traded entity.⁵¹⁰ Following the spinoff, Windstream will continue to exert control over the use of the property held by the REIT through the long-term lease agreement between the two public companies.⁵¹¹ The structure requires: a separate public offering; multiple entities, which will not be under common ownership

505. See *supra* text accompanying notes 472–90.

506. Commentators have proposed bifurcation in other contexts. See, e.g., Borden, Brown & Wagner, *supra* note 142, 312–14 (proposing an elective regime for bifurcation of investment income from ordinary income in the real estate development context).

507. See *supra* text accompanying notes 402–11.

508. See *supra* Part II.C.6.

509. See *supra* text accompanying notes 398–411.

510. See Windstream News Release, *supra* note 332.

511. See *id.* (providing that the operating corporation will enter into a long-term triple-net lease with the REIT).

following the spinoff; and complex financing arrangements. Tax law explicitly blesses this type of income bifurcation,⁵¹² which effectively exempts passive real estate income from the corporate tax. Because tax law explicitly allows income bifurcation through the use of a complex structure, perhaps it should consider allowing corporations to bifurcate income without the structure.

To bifurcate income within a single corporate structure, tax law would have to draw the line between income exempt from corporate tax and income subject to it. The current REIT regime provides a framework for bifurcating passive income from operating income. REITs that have taxable REIT subsidiaries must determine whether any tenant revenues include payment for the subsidiary services; the REIT must pay tax on any services revenue that it does not pay to the taxable REIT subsidiary, and the subsidiary must pay regular corporate tax on its income.⁵¹³ A bifurcation regime could use rules that are similar to the current regime's rules for identifying income attributable to the use of property and income attributable to services. For example, the law could provide that absent evidence to the contrary, income from noncustomary tenant services or management and operation of the property would equal no less than 150% of the cost of providing the services.⁵¹⁴ All income determined to be from services would be subject to an entity-level tax, all rental distributed rental income would be taxed at the investor level.

The Windstream structure includes a long-term lease between the operating company and REIT.⁵¹⁵ That agreement includes rental terms and establishes the amount of income that the REIT will recognize from renting the property to the corporation. Even with such an agreement, the parties may struggle to establish the appropriate amount of market rent,⁵¹⁶ but the separation of operations and ownership provides a greater likelihood that the rent will be arm's length. The bifurcation approach would require a separate determination of arm's length rental income, so lawmakers would have to devise a method for computing the appropriate amount of deemed rental income.

512. See *supra* Part II.C.7.

513. See *supra* text accompanying notes 289–93.

514. The law currently applies this 150% test to operating and management services, and to the amount of redetermined rents for services provided by a taxable REIT subsidiary. See I.R.C. § 857(b)(7)(B)(v), (D) (2012); *supra* text accompanying notes 291–93.

515. See Windstream News Release, *supra* note 332.

516. 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).

If tax law can adequately separate real estate income from other income, it could exempt the real estate income from the entity-level corporate tax. To maintain consistency with the current REIT rules, such a bifurcation regime would have to require corporations to distribute at least 90% of such income.⁵¹⁷ The distribution requirement could help ensure that the transparency of the current system would not be lost. Nonetheless, the system could dampen investment in real estate because investors who acquire stock in a corporation that adopts the bifurcation approach may not be able to direct the use of their investment proceeds. Consequently, the bifurcation regime would impair the ability to manage the diversification of an investment portfolio because investors would have to buy stock in corporations that had both operations and real estate. The regime could inhibit small investors' ability to invest in real estate because their options would be curtailed if both operations and real estate resided within a single entity.

The effect that bifurcation would have on the flow of capital to real estate markets is less clear, but it could be negative. The REIT regime provides investors the opportunity to monitor management of real estate specifically.⁵¹⁸ Investors have less monitoring ability and less influence over the management of real estate if a single entity owns real estate as part of an operating business. Consequently, the effectiveness of real estate monitoring would be diminished under a bifurcation regime, and the efficiency gains that bifurcation may provide with simpler structures may be offset by such losses.

The bifurcation may not measurably advance equity. Under the bifurcation approach, the law would continue to treat different types of income differently. It would also treat corporate income differently from partnership income. Consequently, bifurcation does not measurably advance equity. This suggests that although bifurcation would eliminate complex structures, it would not provide a significant improvement over the current system.

D. Scorecard of Reform Alternatives

The discussion of the reform alternatives reveals that each alternative presents policy challenges. No alternative appears capable of achieving all policy objectives, but some may achieve more objectives than others. Assessment of the various alternatives is a largely qualitative endeavor, but Table 1 presents

517. See *supra* note 86 and accompanying text.

518. See *supra* text accompanying notes 421–24.

a scorecard that summarize and provides some clarity to the analysis of the various reform alternatives. The scorecard is not without its limits. For instance, it does not attempt to prioritize objectives. Instead it assigns equal weight to each policy objective and to optics. It also includes a category for political feasibility of an alternative. It then scores the extent to which an alternative achieves or fails to advance a particular policy objective. If a reform alternative clearly achieves a policy objective, the alternative receives a plus (+) for that policy objective. If an alternative clearly fails to achieve a policy objective, it receives a minus (-) for the objective. If the alternative's effect on a policy objective is unclear or negligible, then it receives a zero for that objective. The scorecard assigns a value of one to pluses and a value of negative one to minuses to create a score for each alternative.

Table 1: Scorecard of Reform Alternatives

Alternatives	Objectives							Total
	Stem Tax- Base Erosion	Promote Equity	Promote Efficiency	Improve Optics	Support Small Investors	Channel Capital to Real Estate	Politically Feasible	
Maintain Status Quo	-	0	0	0	+	+	+	2
Prohibit REIT Spinoffs	0	0	0	+	-	-	-	-2
Narrow Definition of Real Property	+	0	0	+	-	-	-	-1
Restrict Services REITs Perform	0	-	-	0	-	-	-	-5
Repeal REIT Taxation	+	0	0	+	-	-	-	-1
Alter Retirement- Savings Policy	+	+	0	0	0	-	-	0
Eliminate Double Tax	-	+	+	+	+	-	-	1
Expand Entity-Level Tax	+	+	+	+	-	-	-	1
Accommodate Bifurcation	-	0	0	+	-	-	-	-3

Maintaining status quo scores the highest under this system. This is not surprising because even though REITs may have a nominal negative effect on tax revenue, they provide other non-tax benefits to society and the economy.⁵¹⁹ The qualitative analysis above also concludes that while REIT taxation is part of a tax system that treats different types of income and entities differently, the manner in which the law treats REITs is not inherently inequitable.⁵²⁰ Property owners use complex structures to obtain preferential tax treatment, which causes inefficiencies,⁵²¹ but those structures provide non-tax benefits such as providing greater opportunities to diversify and greater access to monitor real estate management.⁵²² Consequently, REIT taxation does not seriously violate any tax-policy objective. On the positive side, REIT taxation provides greater investment opportunities for a broad cross section of the population, it helps channel capital to the real estate markets, and it appears to help stabilize real estate markets.⁵²³

The only other reform alternatives that have positive scores are eliminating double tax and expanding entity-level tax. Those alternatives have positive scores because they could reduce the negative tax-revenue effect of REIT taxation, and they could also help improve equity and efficiency. Nonetheless, they would negatively affect the investment opportunities provided by REIT taxation, and they would likely stem the flow of capital to real estate markets. As a result, they do not score as well as maintaining the status quo.

V. CONCLUSION

The findings in this Article lead to the conclusion that the current discussion of REIT reform is much ado about nothing, and results from bad optics caused by misinformed understandings of the effects of REIT taxation. REIT taxation does not have a significant negative effect on government tax revenues, and it does not appear to offend any particular tax policies. REIT taxation is thus a benign component of the tax system from a traditional tax-policy standpoint. On a positive note, REIT taxation provides significant non-tax benefits to investors, the real estate market, and the broader economy. Consequently, Congress should not take action to significantly curtail the scope of REIT taxation. Instead,

519. See *supra* Part III.A.

520. See *supra* Part III.B.

521. See *supra* Part III.C.1.

522. See *supra* Part III.C.2.

523. See *supra* Part IV.A.

it and Treasury may be well served to further study REIT taxation and consider whether less intrusive methods exist to improve REIT taxation in ways that benefit investors and the economy.

APPENDIX A: REIT MARKET CAPITALIZATION AND GDP DATA

End of Year	All REITs				Equity REITs			Mortgage REITs			Hybrid REITs			GDP
	# of REITs	Market Cap	Avg. Market Cap	Market Cap as % of GDP	# of REITs	Market Cap	% of Total Cap	# of REITs	Market Cap	% of Total Cap	# of REITs	Market Cap	% of Total Cap	
1971	34	\$1,494	\$44	0.13%	12	\$332	22%	12	\$571	38%	10	\$592	40%	\$1,168
1972	46	\$1,881	\$41	0.15%	17	\$377	20%	18	\$775	41%	11	\$729	39%	\$1,282
1973	53	\$1,394	\$26	0.10%	20	\$336	24%	22	\$517	37%	11	\$540	39%	\$1,429
1974	53	\$712	\$13	0.05%	19	\$242	34%	22	\$239	34%	12	\$232	33%	\$1,549
1975	46	\$900	\$20	0.05%	12	\$276	31%	22	\$312	35%	12	\$312	35%	\$1,689
1976	62	\$1,308	\$21	0.07%	27	\$410	31%	22	\$416	32%	13	\$483	37%	\$1,878
1977	69	\$1,528	\$22	0.07%	32	\$538	35%	19	\$398	26%	18	\$592	39%	\$2,086
1978	71	\$1,412	\$20	0.06%	33	\$576	41%	19	\$340	24%	19	\$496	35%	\$2,357
1979	71	\$1,754	\$25	0.07%	32	\$744	42%	19	\$377	21%	20	\$633	36%	\$2,632
1980	75	\$2,229	\$31	0.08%	35	\$942	41%	21	\$510	22%	19	\$847	37%	\$2,863
1981	76	\$2,439	\$32	0.08%	36	\$978	40%	21	\$541	22%	19	\$920	38%	\$3,211
1982	66	\$3,299	\$50	0.10%	30	\$1,071	32%	20	\$1,133	34%	16	\$1,094	33%	\$3,345
1983	59	\$4,257	\$72	0.12%	26	\$1,469	34%	19	\$1,406	34%	14	\$1,329	31%	\$3,638
1984	59	\$5,085	\$86	0.13%	25	\$1,795	35%	20	\$1,801	35%	14	\$1,489	29%	\$4,041
1985	82	\$7,674	\$94	0.18%	37	\$3,270	43%	32	\$3,162	41%	13	\$1,241	16%	\$4,347
1986	96	\$9,924	\$103	0.22%	45	\$4,336	44%	35	\$3,626	37%	16	\$1,962	20%	\$4,590
1987	110	\$9,702	\$88	0.20%	53	\$4,759	49%	38	\$3,161	33%	19	\$1,782	18%	\$4,870
1988	117	\$11,435	\$98	0.22%	56	\$6,142	54%	40	\$3,621	32%	21	\$1,673	15%	\$5,253
1989	120	\$11,662	\$97	0.21%	56	\$6,770	58%	43	\$3,536	30%	21	\$1,356	12%	\$5,658
1990	119	\$8,737	\$73	0.15%	58	\$5,552	64%	43	\$2,549	29%	18	\$636	7%	\$5,980
1991	138	\$12,968	\$94	0.21%	86	\$8,786	68%	28	\$2,586	20%	24	\$1,596	12%	\$6,174
1992	142	\$15,912	\$112	0.24%	89	\$11,171	70%	30	\$2,773	17%	23	\$1,968	12%	\$6,539
1993	189	\$32,159	\$170	0.47%	135	\$26,082	81%	32	\$3,339	11%	22	\$2,678	8%	\$6,879
1994	226	\$44,306	\$196	0.61%	175	\$38,812	88%	29	\$2,503	6%	22	\$2,991	7%	\$7,309
1995	219	\$57,541	\$263	0.75%	178	\$49,913	87%	24	\$3,395	6%	17	\$4,233	7%	\$7,664
1996	199	\$88,776	\$446	1.10%	166	\$78,302	88%	20	\$4,779	5%	13	\$5,696	6%	\$8,100
1997	211	\$140,534	\$666	1.63%	176	\$127,825	91%	26	\$7,370	5%	9	\$5,338	4%	\$8,609
1998	210	\$138,301	\$659	1.52%	173	\$126,905	92%	28	\$6,481	5%	9	\$4,916	4%	\$9,089
1999	203	\$124,262	\$612	1.29%	167	\$118,233	95%	26	\$4,442	4%	10	\$1,588	1%	\$9,661
2000	189	\$138,715	\$734	1.35%	158	\$134,431	97%	22	\$1,632	1%	9	\$2,652	2%	\$10,285
2001	182	\$154,899	\$851	1.46%	151	\$147,092	95%	22	\$3,991	3%	9	\$3,816	2%	\$10,622
2002	176	\$161,937	\$920	1.48%	149	\$151,272	93%	20	\$7,146	4%	7	\$3,519	2%	\$10,978
2003	171	\$224,212	\$1,311	1.95%	144	\$204,800	91%	20	\$14,187	6%	7	\$5,225	2%	\$11,511
2004	193	\$307,895	\$1,595	2.51%	153	\$275,291	89%	33	\$25,964	8%	7	\$6,639	2%	\$12,275
2005	197	\$330,691	\$1,679	2.53%	152	\$301,491	91%	37	\$23,394	7%	8	\$5,807	2%	\$13,094
2006	183	\$438,071	\$2,394	3.16%	138	\$400,741	91%	38	\$29,195	7%	7	\$8,134	2%	\$13,856
2007	152	\$312,009	\$2,053	2.16%	118	\$288,695	93%	29	\$19,054	6%	5	\$4,260	1%	\$14,478
2008	136	\$191,651	\$1,409	1.30%	113	\$176,238	92%	20	\$14,281	7%	3	\$1,133	1%	\$14,719
2009	142	\$271,199	\$1,910	1.88%	115	\$248,355	92%	23	\$22,103	8%	4	\$741	0%	\$14,419
2010	153	\$389,295	\$2,544	2.60%	126	\$358,908	92%	27	\$30,387	8%	—	—	—	\$14,964
2011	160	\$450,501	\$2,816	2.90%	130	\$407,529	90%	30	\$43,972	10%	—	—	—	\$15,518
2012	172	\$603,415	\$3,508	3.73%	139	\$544,415	90%	33	\$59,000	10%	—	—	—	\$16,163
2013	202	\$670,334	\$3,318	4.00%	161	\$608,277	91%	41	\$62,057	9%	—	—	—	\$16,768
2014	216	\$907,426	\$4,201	5.21%	177	\$846,410	93%	39	\$61,017	7%	—	—	—	\$17,419

* All REIT dollar amounts in millions. GDP dollar amounts in billions.

Source: *National Income and Product Accounts Tables, Table 1.1.5 Gross Domestic Product*, BUREAU OF ECON. ANALYSIS (last updated on Aug. 27, 2015), <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=3&isuri=1&904=1971&903=5&906=a&905=2015&910=x&911=0> U.S.; *REIT Industry Equity Market Cap—Historical REIT Industry Market Capitalization: 1972–2014*, REIT.COM, <https://www.reit.com/data-research/data/us-reit-industry-equity-market-cap> (last visited Sept. 18, 2015).
