Policy Memorandum

FISCAL RESEARCH CENTER

GEORGIA STATE UNIVERSITY
ANDREW YOUNG SCHOOL OF POLICY STUDIES
FISCAL RESEARCH PROGRAM
MARCH 3, 1998

SUBJECT: Grandfathered "Paired-Share" REITs

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I. Background

Congress created Real Estate Investment Trusts (REITs) in 1960 to revitalize an anemic real estate market. The legislation encouraged large numbers of individuals to invest in diversified real estate portfolios of income-producing properties. To qualify as a REIT, a corporation must satisfy specific tests limiting their investments to passive-income activities, i.e., interest on mortgages, lease payments, profits from the sale of properties. Further, REITs must distribute a least 95 percent of their taxable income to shareholders. Because of the income distribution rule, REITs pay no federal income taxes. The dividend payments, however, are fully taxable to the shareholder.

Under the Internal Revenue Code, a REIT must derive at least 75 percent of its income from passive sources. This constraint is designed to limit significantly the operating income REITs receive from non-real estate sources, specifically income from operating their own properties. To work around this limitation, however, RElTs with income generating properties established lease arrangements with third-party operators. This mechanism allows the profits, after payment of its lease obligation, to flow through to the third party.

In the early 1980's, some of the REITs streamlined the system by forming "sister" operating companies to supplant the third-party arrangements. The "paired-share" structure as it became known, paired every owner of a share of REIT stock with a share of stock of the "sister" operating company. Because ownership of the two companies is concurrent, the profits derived from the operations of REIT properties are shared with its stockholders. Supporters of the "paired-share" structure defended the arrangement as essential to maintaining the underlying value of their real estate investments. Simply stated, poor management translates into reduced returns to REIT shareholders.

The "paired-share" structure also promoted tax sheltering by corporations engaged in real estate operations. The corporations shelter a portion of their income by placing their real estate in a REIT and render nontaxable the share of its income paid as "lease payments" to the REIT. The IRS and Congress quickly recognized the potential for abuse under this structure and revised the law in 1984, adopting Section 269B of the Internal Revenue Code. This section essentially disallows a paired-share structure by requiring that two companies seeking to combine operations be examined to see if their joint operations meet the established criteria for a RElT. Out of fairness to existing REITs, the legislation "grandfathered" paired-share REITs established prior to June 30, 1983. Ironically, the four companies that qualified under this rule have used their exemption to engage in the very practices Congress sought to end.

II. The Fortunate Four

As noted, the Deficit Reduction Act of 1984 effectively ended the paired-share REIT, but the grandfather rules were generous. They provided the four-paired-share REITs time to unwind their operations, but gave no timeframe for that process. As a result, the four beneficiaries of the 1984 rules have taken no steps to unwind, and in fact, have moved aggressively in the opposite direction. When the grandfather date was set, one of the four, Hotel Investors Trust (HOT) was in dire financial trouble and had sought bankruptcy protection. It was rescued from default by a financially astute group of real estate investors, Starwood Capital. Over time and through a series of financial maneuvers, the group greatly expanded the company's real estate holdings. One measurer of Starwood's current financial strength is their $9.8 billion (*Wall Street Journal* November 4, 1997) takeover bid for ITT. According to the *Wall Street Journal* (October 22, 1997), the merger between the paired-share entities Starwood Lodging Corporation and Starwood Lodging Trust should cut ITT's tax liability by $300 million.

Another paired-shared REIT, Patriot American Hospitality, is also exploiting the open--ended unwind rules. They announced in December of 1997, their intent to purchase Interstate Hotels Corp. of Pittsburgh for $2.1 billion. In a press release, Mr. Paul Nussbaum, Chair and CEO of Patriot, stated the 222-hotel purchase only "underscores the growth opportunities afforded by the company's valuable paired-shared ownership structure." (*Tax Notes*, December 22, 1997, p. 1301)

The two remaining paired-share REITs, Santa Anita Realty Enterprises and First Union Real Estate Equity & Mortgage Investments, also remain active companies and show no indication of winding down their paired share activities. While their acquisitions have not attracted the media coverage of the other two REITs, they too have significant growth potential.

III. Policy Issues

The unresolved aspect of Congresses' effort to close the door on paired-shared REITs introduces a number of troubling affects. Of the possibilities one might consider, three issues standout.

A. The Affect On the Treasury

It is clear from the congressional record that potential tax abuse was the catalyst for amendment Section 269B of the Internal Revenue Code. As borne out by the recent merge offers of Starwood and Patriot American Hospitality, Congress correctly anticipated that REITs would manipulate lease payments arrangements to tax shelter income of their management companies. If the Wall Street Journal's tax liability figure for the ITT merge is even reasonably close, the cost to the Treasury is substantial and only can be expected to grow as the grandfather loophole is exploited still further.

B. The Affect on Market Competition

The exemption for the "fortunate four" is totally contrary to the notation of market competition. As the ITT and Interstate Hotels Corp. acquisitions demonstrate it fosters horizontal mergers that can lead to a lessening of competition within a segment of the real estate market. As noted above, hotels managed by paired-shared REITs have a distinct tax advantage over hotel operators outside this arrangement. The forecasted reduced tax liability improves the operators cash flow, placing them in a stronger competitive position vis-a-vis their competitors. They are able to pursue a more aggressive pricing structure and have additional revenues to fund advertising and other programs aimed at attracting their competitors' customers.

There is also a strong likelihood that the "paired-shared" structure will spread to other segments of the real estate market. For example, the REITs, through mergers and acquisitions, could consolidate ownership of commercial real estate space within targeted local markets. While the national market for commercial properties remains competitive, local markets can be adversely impacted by such tax shelter driven consolidations.

C. The Affect on Capital Markets

The grandfathered position of the "fortunate four" produces two distorting effects in the capital markets. First, because of their special status, paired-share REITs are the beneficiaries of inflated operating company lease payments, 95% of which must be paid out to their shareholders in the form of dividends. As a result, the return to paired-share stockholders should exceed that received by investors in other REITs, other things being the same. Recognizing the higher potential gain associated with a paired-share stock, investors interested in investing in REITs will favor the "fortunate" ones over the unfortunate REITs. Thus, the current loophole is both discriminatory, placing the 192 other REITs at a competitive disadvantage, and inefficient, i.e., causing investment capital to respond to perverse non-market incentives.

Second, the attractiveness of the paired-share REIT structure extends beyond the equity market for REITs. To fuel their expansionary plans, the paired-share REITs must attract large sums from the broader market for equity and debt issues. The funds will be forthcoming because of their special status and the perceived higher returns it bestows. Thus, the grandfather rules introduce further distortions by siphoning investment funds from productive uses in other segments of the capital markets to finance counter-productive investments elsewhere. The process also produces windfall gains for stockholders of merged companies as the projected tax savings are factored into earnings.

IV. Policy Alternatives

There are a number of different ways to correct the abuses and distortions introduced by the grandfathering exemption, but of the possibilities, four alternatives are offered. To a large extent, the elected corrective solution depends upon the weight one places on the identified problems.

A. End the Paired-Share Grandfathering Rules and Disallow Abusive Acquisitions

The cleanest and most unambiguous solution is to end the paired-share grandfathering rules and to disallow abusive acquisitions. In essence, this alternative reaffirms Congresses' 1984 decision

decision to close the identified paired-share REIT tax loophole. Further, it sends a clear message that Congress is ending the practice, with no exceptions or special historical privilege.

Under this solution pending acquisitions and mergers of the "grandfathered four" would be barred if they fail to qualify for REIT status under Sections 269(B) and 856(c) and (d) of the Internal Revenue Code. The former section requires that the *combined* entities qualify for REIT status. By this standard, a merger between a taxable corporation with significant active income from operations and a REIT is prohibited if the combined entities fail to meet the 75% passive-income rule.

Under the Tax Reform Act of 1986, all REITs are allowed to perform directly those services customarily rendered to tenants. Section 856(c) and (d), however, clarifies the amount of tenant service income a REIT may earn from these services. Without going into the details of the rules and definitions, the "gross income test" is designed to disqualify abusive lease payment arrangements like those contemplated in the Starwood/ITT merger, and permitted under the paired-share framework. Specifically, it is unlikely that all of the income paid to Starwood through the net lease payments is regarded as "rents from real property" under section 856(d); but instead it is operating income from furnishing services and lodging to guests. Thus, the lease payment arrangement would fail to meet the section 856 test, and Sherwood would be disqualified as a REIT.

The proposed solution should also include a defined time period for the paired-share REITs to comply with the current REIT legislation. As a benchmark, foreign corporations were given two years to make the transition in 1984.

B. End the Paired Share Grandfathering Rules and Prohibit "Re-Election" of Paired-Share REIT Status

Similar to solution A above, this alternative reaffirms Congresses' decision to end the abusive aspects of the paired-share REIT structure. The grandfathered status of the fortunate four is revoked and all REITs formed after, say February 1, 1998, must comply with the current REIT legislation. Unlike solution A, however, pending paired-share REIT acquisitions are allowed to go forward and are not screened for compliance with sections 269(B) and 856(c) and (d) of the Internal Revenue Code. As in alternative A, Congress sets a date for phasing out the paired-share REIT structure altogether. Previously disqualified or terminated paired-share REITs are not permitted to re-elect their former status. This is a reasonable position to take given Congress' original intent and the burdens such an election produces in other segments of the economy. Because the Starwood/HOT entity failed to comply with the REIT requirements during the period 1991 through 1994, applying this principle effectively outlaws the purposed Starwood/ATT merger. It also bars a reported request for re-election by Hollywood Park Inc. from occurring (*Wall Street Journal*, October 24, 1997). Thus, denying re-election requests limit to some extent the unwanted growth of paired-share REITs, but it only provides a partial solution to the problem. On equity as well as efficiency grounds, solution A is a better alternative.

C. Disallow Abusive Paired-Share REITs

This solution maintains the status of the existing paired-share REITs, but stipulates that over some reasonable timeframe they comply with sections 269(B) and 856(c) and (d) of the Internal Revenue Code. In essence, REITs unable to meet current legislative standards are given notice that they must restructure and become compliant within a defined period of time, say two years.

This alternative permits pending paired-share REIT mergers to go forward, and does not require that they adhere to current REIT legislation. Clearly, during the transition period, this solution invites and sanctions abuses by the paired-share REITs, i.e., substantial lost of tax revenues, horizontal inequities and investment distortions. On the other hand, it signals an end to the identified problems without retroactive legislation.

D. Limit Payments From Paired-Share Operations

The above alternatives essentially look to current legislation for guidance in formulating constructive solutions to the abusive aspects of the paired-share REIT structure. Another alternative to forced compliance, is to simply limit their non-passive income activity by restraining the amount of income they derive from third party or paired-shared operations. For example, stating that active income must be less than x percent of the REITs passive assets. Or, by stating that a paired-share REIT's active income may not increase by more than x percent per year, or by a total of x percent. Clearly, an investigation of the appropriate criteria or baseline financial measure is necessary before proceeding with this alternative.

Document Metadata

This document was retrieved from IssueLab - a service of the Foundation Center, http://www.issuelab.org
Date information used to create this page was last modified: 2014-02-15

Date document archived: 2010-08-06

Date this page generated to accompany file download: 2014-04-15

IssueLab Permalink: http://www.issuelab.org/resource/grandfathered_paired_share_reits

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Date Published: 1998-03-03

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Subject(s): General