Taxable REIT Subsidiaries: Analysis of the First Year's Returns, Tax Year 2001

by Thornton Matheson

The Real Estate Investment Trust (REIT) Modernization Act, Part II, Subpart A of Public Law 106-170, the "Ticket to Work and Work Incentives Improvement Act," enacted on December 17, 1999, created the taxable REIT subsidiary (TRS), which allows a REIT to offer a more complete range of services to its tenants without jeopardizing its status as a REIT. The REIT Modernization Act (RMA) also denied tax deductions for interest on loans from parent REIT's to TRS's in cases of excessive leverage [1].

The RMA mandated that "[t]he Secretary of the Treasury shall conduct a study to determine how many taxable REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries" and submit its findings in a report to Congress [2]. This article was written in fulfillment of that mandate and, more generally, to examine the new entities' fiscal characteristics.

In 2001, the year in which the RMA took effect, 480 firms filed Form 8875, *Taxable REIT Subsidiary Election*. Of these, 404 filed Form 1120, *U.S. Corporate Income Tax Return*, and paid $85.4 million in taxes for 2001 [3]. Of these TRS's, 154 were newly established entities and the remainder pre-existing entities. Although TRS's are highly leveraged as a group, with approximately one third of firms showing negative equity on their balance sheets, loans from parent REIT's to TRS's do not appear to be prevalent. Fewer than 8 percent of TRS's have loans from shareholders, and such loans account for less than 4 percent of total TRS debt. TRS's that do have loans from shareholders tend to be more highly leveraged than other TRS's and have negative total equity as a group.

Background

Created by Congress in 1960, REIT's provide a vehicle for investment in real estate. As long as an entity otherwise qualifies as a REIT and distributes at least 90 percent of its income to investors as dividends, those dividends are deducted in computing the REIT's taxable income[4]. Two income tests ensure that REIT's are used predominantly to invest passively in real estate: (1) at least 95 percent of a REIT's income must be derived from "passive" financial investments, including rents, dividends, interest, and capital gains, as opposed to "active" income from business activities; and (2) at least 75 percent of a REIT's income must be derived from real estate sources including rents, mortgages, and capital gains on real estate.

REIT's are restricted in terms of the kinds of services they can provide their tenants. Specifically, a REIT may provide "customary real estate services" to its tenants, but providing more than a de minimis amount of impermissible services (for example, housekeeping services) at a particular property prevents rents from that property from qualifying as rents under the REIT income tests. REIT's argued that the constraints placed on their activities by the "customary services" requirement prevented them from competing effectively with non-REIT real estate firms.

Because REIT's were limited in the services that they could provide their tenants directly, before the enactment of the RMA many REIT's established third-party subsidiaries (TPS's) to provide such services. Since distributions to the parent REIT's from these subsidiaries were dividends, the distributions qualified for the 95-percent income test, but they did not qualify for the 75-percent income test.

In addition to the 95-percent and 75-percent income tests, REIT's must also satisfy several quarterly diversification tests, including: 1) the securities of any one issuer must not constitute more than 5 percent of the value of a REIT's total assets; and 2) prior to the enactment of the RMA, a REIT could not hold more than 10 percent of the voting securities of any issuer other than another REIT [5]. In order to comply with the latter test, a REIT would typically own only 10 percent of the voting shares of a TPS; however, it would own close to 100 percent of the value of nonvoting stock, preferred stock, or debt. To ensure that the subsidiary acted in the best interest of the REIT, the remainder of the voting shares of the TPS were often held by the REIT's managers or shareholders [6].

The REIT Modernization Act

The RMA allowed REIT's to establish taxable REIT subsidiaries, which are subject to the corporate

Thornton Matheson is a financial economist with the Treasury Department's Office of Tax Analysis.

income tax, but not to the regular REIT diversification tests. Although securities of a single issuer (other than another REIT) may generally constitute no more than 5 percent of a REIT's assets, securities of one or more TRS's may constitute up to 20 percent of a REIT's assets as measured by fair market value. In addition to the 10-percent limit on REIT holdings of a single entity's voting stock, the RMA added the requirement that a REIT can own no more than 10 percent of the outstanding value of the securities of a single issuer (other than another REIT). Certain exceptions to these rules are allowed: Specifically, a REIT may own 100 percent of the vote and value of a TRS [7]. The RMA also permitted tax-free conversion of TPS's into TRS's. Like dividends from TPS's, dividends from TRS's qualify for the 95-percent income test, but not for the 75-percent income test.

In 2001, there were 404 TRS's with total assets of $19.4 billion and total gross income of $8.1 billion. The total TRS tax bill was $85.4 million.

The RMA placed limits on the amount of interest and rents that a TRS can pay to a parent REIT and on what it could charge tenants for its services. For example, the amendment of section 163(j) to apply to interest paid by a TRS to its parent REIT permits deduction of such interest only if the debt-to-equity ratio of the TRS is at most 1.5, or if the ratio of its interest payments to its net income before interest, net operating losses, and depreciation (i.e., the inverse of its interest coverage ratio) is at most 0.5. The limitation does not apply to interest on debt held by third parties, even if guaranteed by the parent REIT.

Similarly, for rents paid by a TRS to a parent REIT to qualify as rents from real property for purposes of the 95-percent and 75-percent gross income tests, a TRS may rent no more than 10 percent of any property from a parent REIT and must pay rent comparable to that of other tenants. A 100-percent excise tax is levied on income from certain transactions between a parent REIT and its TRS that are found in an audit to be non-arm's length. The 100-percent excise tax does not apply if: 1) the REIT charges substantially comparable rents to tenants who do and do not receive the TRS services; 2) the TRS charges substantially comparable prices for services to REIT tenants and to unrelated third parties; or 3) the gross income from TRS service charges is at least 150 percent of the direct costs of providing those services.

Analysis of the Data

The RMA directed the Treasury Department to publish data on the number of TRS's created subsequent to its passage and on the total amount of corporate tax paid by those entities. In addition, this study provides a more general description of the fiscal characteristics of the TRS's formed in the first year following the RMA's effective date (December 31, 2000), with particular attention to the potential for earnings stripping.

The data used for this analysis were compiled by the Internal Revenue Service's Statistics of Income division (SOI) from REIT Form 1120-REIT and TRS Form 1120, *U.S. Corporate Income Tax Return*, and Form 8875, *Taxable REIT Subsidiary Election*. The corporations analyzed are TRS's that filed Form 8875 as well as Form 1120 for Tax Year 2001. The data on these TRS's are from the SOI Corporate Database or the IRS Business Master File (BMF). The BMF includes all corporate tax returns from a given tax year, for which a limited number of items from Form 1120 are available. The SOI Corporate Database is a stratified probability sample of the BMF that captures most Form 1120 entries. Although the Corporate Database generally weights firms according to asset size and income, the data used in this study were selected by employer identification number to match firms that filed Form 8875 in 2001 and are unweighted because they represent the universe of TRS's.

For 2001, a total of 404 firms in either the SOI Corporate Database or the IRS BMF filed both Form 8875 and Form 1120. These 404 TRS's identified a total of 183 different REIT's as whole or partial owners of their equity. Ten of the TRS's were wholly or partially (at least one-third) foreign-owned. Figure A describes the distribution of ownership among TRS's and their parent REIT's in 2001. About 86 percent of all TRS's (347 out of 404) had only one parent REIT, while the remainder had multiple REIT shareholders. About half of all parent REIT's had only one TRS, while some established multiple subsidiaries.

Figure A

Real Estate Investment Trusts and Taxable REIT Subsidiaries, 2001

Number of Parent REIT's per TRS

Number of Parent REIT's	Number of TRS's
Total	404
1	347
2	43
3	7
4 or more	7

Number of TRS's per Parent REIT

Number of TRS's	Number of Parent REIT's
Total	183
1	96
2	35
3	19
4	6
5	7
6	7
7 or more	13

[1] TRS = Taxable real estate investment trust subsidiaries.
[2] REIT = Real estate investment trusts

Figure B shows 2001 Form 1120 variables for 173 of the 183 parent REIT'S represented in either the SOI Corporate Database or the BMF, stratified according to asset class [8]. The REIT total asset value was $221 billion, and their total income was $26 billion. Eighty percent of the parent REIT's had more than $100 million in assets, and 38 percent had more than $1 billion in assets. Comparison of columns 3 and 4 of Figure B shows that REIT's with more than $1 billion in assets were more likely to hold shares in multiple TRS's.

Totals of Form 1120 values for TRS's are shown in Figure C, stratified according to TRS asset class. In 2001, there were 404 TRS's with total assets of $19.4 billion and total gross income of $8.1 billion. Total deductions exceeded total income, yielding negative net income of -$151 million. Only the 42 TRS's in the largest asset group, firms with assets of more than $100 million, had positive total net income ($310.8 million). The total TRS tax bill was $85.4 million, 60 percent of which was paid by the 42 TRS's with more than $100 million in assets.

Figures D and E break the full TRS sample into two subsets: TRS's that filed tax returns (mostly Form 1120) prior to 2001, indicating that they were pre-existing entities that elected TRS status, and TRS's that filed their first returns in 2001, indicating that they were newly established enterprises. Comparison of Figures D and E shows that members of the newly established TRS group were more likely to have positive net income than members of the group of older firms. Figure D shows that total 2001 net income for preexisting TRS's was -$352.6 million, as compared to $201.6 million in total net income for the newly established group shown in Figure E. For both subsamples, TRS's with more than $100 million in assets had positive total net income. With the exception of new TRS's with assets of less than $1 million, all of the smaller asset classes had negative total net income.

Total taxes paid by TRS's established before 2001 were $75.7 million; total taxes paid by newly established TRS's were $9.8 million. Whereas preexisting TRS tax remittances followed the pattern observed in the total sample--the largest TRS's payed the lion's share of taxes--remittances from newly established TRS's were spread more evenly among all sizes of firms. Newly established TRS's with less than $1 million in assets paid more in total taxes than the other three asset groups. Among preexisting TRS's, firms with more than $100 million in assets accounted for about two-thirds of tax remittances, while, among newly established TRS's, such firms accounted for only slightly more than 10 percent of tax remittances in 2001.

Figure B

Real Estate Investment Trusts: Selected Items, by Total Asset Size, 2001

[Money amounts are in thousands of dollars]

Asset size	Number of REIT's	Number of TRS's owned	Total assets	Total income
	(1)	(2)	(3)	(4)
Total............................	**173**	**495**	**221,085,239**	**26,201,325**
Less than $100,000,000...	35	65	1,236,563	604,344
$100,000,000 under $1,000,000,000............	73	144	29,542,653	4,687,679
More than $1,000,000,000............	65	286	190,306,023	20,909,302

Figure C

Selected Items from U.S. Corporation Income Tax Returns for Taxable Real Estate Investment Trust Subsidiaries, by Total Asset Size, 2001

[Money amounts are in thousands of dollars]

Item	Total	Asset size: Less than $1,000,000	$1,000,000 under $10,000,000	$10,000,000 under $100,000,000	More than $100,000,000
	(1)	(2)	(3)	(4)	(5)
Number of subsidiaries	**404**	**165**	**96**	**101**	**42**
Total assets	19,428,365	17,813	453,780	3,278,217	15,678,554
Gross receipts	9,517,414	74,145	1,007,080	1,441,543	6,994,645
Cost of goods sold	4,275,800	19,318	144,372	219,246	3,892,864
Gross profits	5,241,615	54,827	862,709	1,222,298	3,101,781
Nonoperating income	2,868,001	7,503	82,919	1,002,166	1,775,413
Total income	8,109,616	62,330	945,628	2,224,463	4,877,194
Total deductions	8,260,585	85,478	1,046,332	2,562,401	4,566,373
Net income (loss)	-150,969	-23,148	-100,704	-337,938	310,821
Total taxes	85,444	5,112	3,889	25,313	51,130

The impact of the RMA's limitations on rental and service charges cannot be gauged from the available tax data. However, the data do permit analysis of the RMA's limitation relating to loans between parent REIT's and their subsidiaries. TRS inverse interest coverage ratios can be calculated from data given on the first page of Form 1120, and data on their debt-to-equity ratios and loans from shareholders are provided on Schedule L. Figure F provides summary statistics of these data. Because Schedule L data were not available for the 65 firms in the BMF database, and 56 of the (mostly smaller) firms in the SOI Corporate Database did not provide Schedule L data, the sample includes only 276 firms.

Figure F shows that loans from shareholders were not widespread among TRS's in 2001: Less than 4 percent of total TRS debt was held by share-holders. Some 180 of the 276 TRS's for which there

Figure D

Selected Items from U.S. Corporation Income Tax Returns for Taxable Real Estate Investment Trust Subsidiaries Established Prior to 2001, by Total Asset Size, 2001

[Money amounts are in thousands of dollars]

Item	Total	Asset size: Less than $1,000,000	$1,000,000 under $10,000,000	$10,000,000 under $100,000,000	More than $100,000,000
	(1)	(2)	(3)	(4)	(5)
Number of subsidiaries	**250**	**80**	**67**	**72**	**31**
Total assets	11,811,959	8,386	304,802	2,302,561	9,196,209
Gross receipts	4,074,474	38,370	454,546	1,198,198	2,383,360
Cost of goods sold	1,440,877	18,187	38,480	197,236	1,186,974
Gross profits	2,633,597	20,183	416,066	1,000,962	1,196,387
Nonoperating income	1,944,560	-8,339	64,402	932,295	956,202
Total income	4,578,157	11,843	480,468	1,933,257	2,152,589
Total deductions	4,930,721	45,186	516,111	2,246,887	2,122,538
Net income (loss)	-352,563	-33,342	-35,642	-313,630	30,051
Total taxes	75,664	122	3,300	22,368	49,874

Figure E

Selected Items from U.S. Corporation Income Tax Returns for Taxable Real Estate Investment Trust Subsidiaries Established in 2001, by Total Asset Size, 2001

[Money amounts are in thousands of dollars]

Item	Asset size				
	Total	Less than $1,000,000	$1,000,000 under $10,000,000	$10,000,000 under $100,000,000	More than $100,000,000
	(1)	(2)	(3)	(4)	(5)
Number of subsidiaries	**154**	**85**	**29**	**29**	**11**
Total assets	7,616,406	9,427	148,978	975,656	6,482,345
Gross receipts	5,442,940	35,775	552,534	243,346	4,611,285
Cost of goods sold	2,834,923	1,131	105,892	22,010	2,705,891
Gross profits	2,608,017	34,644	446,643	221,336	1,905,394
Nonoperating income	923,441	15,843	18,517	69,871	819,211
Total income	3,531,458	50,487	465,159	291,206	2,724,605
Total deductions	3,329,864	40,292	530,221	315,515	2,443,836
Net income (loss)	201,594	10,195	-65,062	-24,308	280,770
Total taxes	9,780	4,990	589	2,945	1,257

Figure F

Selected Items from U.S. Corporation Income Tax Returns for Taxable Real Estate Investment Trust Subsidiaries, by Total Asset Size, 2001

[Money amounts are in thousands of dollars]

Item	Asset size				
	Total	Less than $1,000,000	$1,000,000 under $10,000,000	$10,000,000 under $100,000,000	More than $100,000,000
	(1)	(2)	(3)	(4)	(5)
Total assets	19,145,262	12,902	400,200	3,155,506	15,576,653
Total debt	11,860,490	27,333	424,805	2,254,942	9,153,410
Loans from shareholders	395,687	122	52,922	121,486	221,158
Total equity	7,284,772	-14,431	-24,605	900,564	6,423,243
Number of subsidiaries	276	50	87	98	41
Number of subsidiaries with debt/equity ratio ≤ 1.5	101	22	29	38	12
Number of subsidiaries with inverse interest coverage ratio ≥ 0.5	151	43	53	38	17
Number of subsidiaries passing either debt/equity or interest coverage test	180	46	60	54	20
Number of subsidiaries with negative equity	86	25	29	26	6

were Schedule L data would have qualified to deduct interest on loans from parent REIT's: 101 TRS's had nonnegative debt-to-equity ratios of at most 1.5, and 151 TRS's had nonnegative inverse interest coverage ratios of at most 0.5. Figure F also shows that TRS's tend to be highly leveraged: 86 of the 276 TRS's have negative equity, and total equity is negative for firms with less than $10 million in assets.

Figure G shows the Schedule L data for the subset of TRS's that had outstanding loans from shareholders in 2001. Because this group of 21 firms is relatively small, the data had to be aggregated into larger asset size groups and data on debt-to-equity and interest coverage ratios suppressed in order to preserve confidentiality. Fewer than 8 percent of TRS's that provided Schedule L data had outstanding loans from shareholders in 2001. For this group, total loans from shareholders accounted for 9.6 percent of total debt, but this ratio varied greatly according to asset size. Loans from shareholders constituted a much higher percentage of total debt for TRS's with less than $10 million in assets than for larger TRS's, which presumably had greater access to other sources of credit. Twelve of the 21 TRS's with

Figure G

Selected Items from U.S. Corporation Income Tax Returns for Taxable Real Estate Investment Trust Subsidiaries with Loans from Shareholders, by Total Asset Size, 2001

[Money amounts are in thousands of dollars]

Item	Asset size: Total	Less than $10,000,000	$10,000,000 under $100,000,000	More than $100,000,000
	(1)	(2)	(3)	(4)
Total assets	2,001,192	33,192	283,078	1,684,922
Total debt	2,021,460	65,977	233,139	1,722,343
Loans from shareholders	395,687	53,044	121,486	221,158
Total equity	-20,268	-32,786	49,939	-37,421
Number of subsidiaries	21	9	6	6
Number of subsidiaries passing either debt/equity or interest coverage test	12	6	3	3
Number of subsidiaries with negative equity	11	5	3	3

loans from shareholders qualified to deduct interest on loans from shareholders under either the debt-to-equity or the interest coverage ratio tests.

TRS's with loans from shareholders are even more highly leveraged as a group than the full sample of TRS's. Total equity for this subsample was negative, and slightly more than half of the firms had negative equity, as compared to 31 percent of the sample in Figure F.

Conclusion

The REIT Modernization Act of 1999 changed the REIT asset tests to allow the creation of wholly owned corporate subsidiaries that could offer noncustomary services. In the year that the legislation took effect (2001), 183 REIT's responded by establishing 404 taxable REIT subsidiaries, 154 of which were newly created firms and the remainder of which were pre-existing entities. In 2001, these 404 TRS's generated $8.1 billion in gross income with assets of $19.4 billion, and had negative net income of -$151 million. Pre-existing entities (such as TPS's) that elected to be taxed as TRS's were more likely than newly established TRS's to have negative net income. TRS's paid a total of $85.4 million in taxes in 2001, some 60 percent of which came from the 10 percent of TRS's with more than $100 million in assets.

In general, TRS's tend to be highly leveraged: Close to a third of the TRS's that filed Schedule L's showed negative equity on their balance sheets. However, TRS borrowing from parent REIT's does not appear to be prevalent: Fewer than 8 percent of TRS's reported positive loans from shareholders, and debt to shareholders accounted for less than 4 percent of total TRS debt. TRS's with loans from shareholders tend to be more thinly capitalized than average. More than half of these firms had negative equity, and 52 percent qualified under either the debt-to-equity or the interest coverage ratio tests for interest deductibility on those loans, compared to a qualification rate of 65 percent for the full sample of TRS's.

Footnotes

[1] This change was accomplished by applying paragraph (3) of section 163(j) of the Internal Revenue Code.

[2] Ticket to Work and Work Incentives Improvement Act of 1999, Public Law 106-170, December 17, 1999, Title V, Part II, Subpart A, Section 457.

[3] The number of Form 8875 filings likely exceeds the number of Form 1120 filings because some firms filed Form 8875 prospectively and either did not initiate business in 2001 or otherwise did not qualify.

[4] Between 1980 and 2000, REIT's were required to distribute at least 95 percent of their incomes in order for the REIT provisions, including the

deduction for dividends paid, to apply. The REIT Modernization Act reduced this ratio to its original 90 percent, equal to the distribution requirement for regulated investment companies (RIC's).

[5] The RMA amended the second asset diversification test to require that a REIT hold no more than 10 percent of the vote or value of a non-REIT's securities.

[6] Joint Committee on Taxation (2001), *General Explanation of Tax Legislation Enacted in the 106th Congress*, Washington, DC, U.S. Government Printing Office, p. 68.

[7] Other exceptions to the 10-percent vote or value restriction include straight debt, mortgage loans from a REIT to its TRS, and certain grandfathered securities held or contracted for by a REIT as of July 12, 1999.

[8] Since the BMF contains all business returns filed in a given tax year, the ten missing REIT's likely did not file 1120's in 2001.

Source: IRS, Statistics of Income Spring Bulletin, Publication 1136, June 2005.