Practical Considerations for the Taxation of Real Estate Investment Trusts

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US Tax Structure of REITs

• Broadly, exempt from corporate taxes; limited to real estate activities and must distribute income as dividends

• Initially, a stricter interpretation of allowable activities, constraining REITs’ ability to operate and manage their assets; with Tax Reform Act of 1986, a more active role

• Dividends are deductible from corporate taxable income; at least 90 percent (and in practice 100 percent) of is paid out

• REIT taxed as a pass-through entity, effectively operating free of corporate taxes at the federal level; tax burden falls on investors
• States and local governments may impose a range of alternative taxes, such as taxes on gross receipts and transfer taxes

• REITs are undifferentiated from other owners of real property in their property tax obligations
  – However, may bear a disproportionate property tax burden if shareholders’ return expectations are lower than direct real estate investors’
  – In markets where REITs are a significant share of activity, feedback mechanisms imply that REIT acquisitions will influence all values
US Tax Structure of REITs

• REITs are attractive to investors seeking regular cash distributions in their portfolios; affords tax-advantaged real estate opportunities to small investors without business risk or scale requirements of direct ownership

• For the purposes of federal taxes in the United States, REIT distributions are not dividends; taxed as ordinary income, should be sensitive to ordinary income tax rate

• Globally, shared features of REITs across regulatory regimes include limits on income sources, income distribution requirements, and pass-through tax treatment of distributed income
Tax Rates and Dividend Payouts

• Relevance of structure will depend on efficiency of corporate and personal income tax regime, encompassing performance and evasion by corporate and individual taxpayers

• If dividends are endogenous in the tax rate, an increase in the rate will produce a relatively smaller increase in tax revenue

• Mixed evidence on whether dividends respond to tax rate changes; dividends increased following effective rate cut in 2003 but causality is unclear
  – Although REIT dividends did not qualify for the lower rate, REIT dividend payouts increased, suggesting a different causal factor (Edgerton, 2012)
Broad Set of Issues to Consider

• What are the underlying and country-specific objectives in facilitating a REIT market

• Is the design of the tax structure conducive to the development and proper functioning of the REIT market
  – Taxation on gains at election will present a barrier to entry but will not materially alter the long-term economics; issue of critical mass for liquidity and research coverage
  – Dividend distribution taxes on internal transfers between SPVs and their parents will discourage prudent ringfencing of property-specific risk

Incomplete Assessment

• Does the liquidity and operating fundamentals performance of the domestic real estate market present unusual risks for retail investors
Broad Set of Issues to Consider

• Does the domestic real estate market’s level of informational transparency to retail investors expose them to risks that are not well understood

• Will REITs’ preferential tax status reduce capital availability or increase costs to other sectors

• Does the design of the tax structure have implications for macro prudential policies, because of its impact on revenue, investor exposure to the sector, or procyclical influence on asset prices

• To what extent is optimization of the tax structure constrained in an analysis of the political economy — e.g. the case of REIT spinoffs and corporate inversions
# REIT Market Stakeholders

## Hypothetical Preference Matrix

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<tr>
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<th>Pass-Through Status of REIT, Ordinary Taxation of Shareholders</th>
<th>Strict Income Source and Distribution Requirements</th>
<th>Special Taxation of Foreign Investment in REIT Shares</th>
<th>REIT Investment in Foreign Assets</th>
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<td>Domestic Investors / Shareholders</td>
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<td>Domestic Regulator</td>
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<td>Non-REITs w/ Capital Scarcity</td>
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<td>Global Investors / Shareholders</td>
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Taxation of Foreign Investment in Real Estate

- Foreign Investment in Real Property Tax Act (FIRPTA)
  - Tax on non-US investors’ gains from sale of US real property; does not apply when holdings of listed company less than 5 percent

- A more important issue in frontier economies, where the yields on REIT investment may be insufficient to attract domestic retail investors

- Overall liquidity may depend on global capital, aligning interests of domestic on cross-border investors
Taxation of Foreign Investment in Real Estate

• Vigorous lobbying by commercial real estate industry groups to repeal the 1980 act

  In the view of the National Association of Real Estate Investment Trusts: “as a practical matter, FIRPTA limits the amount that foreign investors are willing and able to invest in US REITs”

• Current proposals (a) increase ownership stake that non-US investor can take in listed real estate company without triggering FIRPTA liability and (b) remove FIRPTA tax penalty on non-US pension funds investing in US property and infrastructure
Risk Mitigation and REIT Tax Structure

REIT constrained by limited capacity to retain earning during periods of economic or financial market weakness

Allowing limited flexibility to pass income above distribution requirement to capital or liquidity reserve may enhance the long-term stability of the REIT market in emerging and frontier economies

Informationally inefficient market compounded by information asymmetry between REIT management and retail investors; by encouraging weakly informed capital flows, REITs may exacerbate the asset price cycle, offsetting benefit of operational discipline

Expand distribution requirements to encompass standardized performance metrics; actively evaluate cyclical features of asset market