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HAS THE TIME FOR LARGE GAMING PROPERTY INVOLVED REITS FINALLY ARRIVED?: A REVIEW OF THE POTENTIAL FOR REIT Investment in Destination Gaming RESORT PROPERTIES

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Table of Contents

I.	Introduction	48	R
II.	Consequences of Demand for Substantial Capital		
	INVESTMENT IN PASSIVE REAL PROPERTY	49	R
III.	POTENTIAL USE OF REITS TO MONETIZE DESTINATION GAMING		
	RESORT INVESTMENT IN PASSIVE REAL PROPERTY	51	R
	REIT QUALIFICATION RULES AND THEIR EFFECT ON THE		
	AVAILABILITY OF REIT BASED MONETIZATION		
	Transactions	55	R
	A. REIT Qualification Rules	55	R
	B. Difficulties in Splitting a Destination Gaming Resort Under		
	Conventional REIT Structuring Arrangements	71	R
	1. Economic Penalties Attaching to Direct Operation of		
	Destination Gaming Resorts	72	R
	2. Potential Inadequacy of Sale Leaseback Solutions	73	R
	3. Inadequacy of Transfer for REIT Equity Solutions	73	R
	C. Promise of Direct Operation Through Partnership Joint		
	Ventures	75	R
	D. Structuring Direct Operation Through Partnership Joint		
	Ventures	79	R
	E. When Additional Restructuring is Required For Improved		
	Tax Efficiency	83	R
	F. Optimal Candidates for Direct Operation Partnership Joint		
	Ventures	84	R
V	Conclusions	85	R

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[Vol. 2:47

I. Introduction

A destination gaming resort is a large hotel strategically located in a desirable resort location that offers fine dining, exceptional entertainment, fashionable facilities and atmosphere, luxury furnishings and services, numerous recreational activities, and features legal gaming. Unlike more modest gaming businesses, destination gaming resorts emphasize both hotel and gaming operations. As a result of this dual emphasis, destination gaming resorts are notable for the scale of their investment in real property, which is often in the billions of dollars. These businesses invest in real property to derive income attributable to payments received from mere occupancy, services related to occupancy, and wagering or gaming activities.¹ In this fashion, they combine real property, services, and gaming based lines of business. By combining fees for the use of real property with services and gaming, destination gaming resorts hold assets and derive income that is, for federal income tax purposes, a mixture of passive and active.²

In simple terms, passive income is a type of income that represents a constant increase in wealth owing to passive accumulation. Passive accumulation is an accession to wealth that accrues without a taxpayer's exertion or sacrifice and is therefore primarily the result of economic conditions beyond a taxpayer's immediate control. Common examples of passive income include merely receiving interest income, royalty income, dividend income, rents from real property, and amounts hotel guests pay for *mere* occupancy. In contrast to passive income, taxpayers derive active income from their work or economy, a product of substantial management, operation, exertion, or sacrifice. In particular, a destination gaming resort's real property dedicated to passive business and passive sources of income³ demand most of its capital investment in real property and represents a distinct area where significant but not exclusively passive income is realized.⁴ In such areas, they realize predominantly passive

¹ In the case of destination gaming resorts, its facilities produce income from supplying guests with both occupancy and services (of both a personal and general nature). The former represents payment from guests for the use of real property, while the latter represents payment from the same guests for the enjoyment of general facility services, hospitality services and gaming. *See infra* note 12.

² For purposes of this article, a reference to passive income or qualifying income means real property rents and other real estate investment trust permissible income sources set out in 26 U.S.C. § 856(d)(1)-(2), (d)(7) (2006 & Supp. II 2008) and Treas. Reg. § 1.856-4 (as amended in 1981), while a reference to active income or non-qualifying income means income that is other than a passive income source. Similarly, passive assets and passive real property refer to real estate assets where predominantly passive business occurs (and other property qualifying under 26 U.S.C. § 856(c)(4) (2006 & Supp. II 2008) such as the hotel tower, while active assets and active real property refer to all assets that do not qualify as passive assets (such as the gaming business and those portions of the real property where gaming is conducted). Additionally, passive business refers to the process of earning passive income, while the term active business refers to the process of earning active income. Notably, investment in passive real property often contains within it opportunities for active business. Income that would constitute a prohibited transaction under 26 U.S.C. § 857(b)(6) (2006 & Supp. II 2008) is treated as neither a passive or active source.

³ For example, its hotel or retail component and general services. *See infra* note 12.

⁴ Such as charges for mere occupancy, general services and triple net rents for retail space. Non-real estate investment trust tax rules typically distinguish between passive mere rental

REIT INVESTMENT

unknown

49

income, but also realize lesser yet significant active income. Consequently, the passive real property components of a destination gaming resort are those distinct segments of the property that yield predominantly, but not exclusively, passive income.⁵ Destination gaming resorts focus equally on active business, in the form of gaming and personal services, and passive business, when gaming revenues are more or less offset by revenues from non-gaming hotel, conference, convention, recreation, retail, and entertainment related facilities.⁶

II. Consequences of Demand for Substantial Capital Investment in Passive Real Property

Gaming resorts on this scale require a massive capital investment, largely to fund their sizable passive real property aspects. In order to acquire the funds needed to invest in real property on this scale, these businesses are or will commonly become publicly traded, allowing them to issue liquid publicly traded debt⁷ and equity but coming at the cost of being taxable as a Subchapter "C" corporation as to all of their active and passive business.⁸ As detailed below, becoming taxable as a Subchapter "C" corporation is detrimental

income and income received in an active trade of renting property by whether the taxpayer supplies significant services and incurs significant costs in management and operation. Treas. Reg. § 1.355-3(b)(2)(iii), (b)(2)(iv) (as amended in 1989); Treas. Reg. § 1.367(a)-2T(b)(3) (as amended in 2008); Treas. Reg. § 1.1362-2(c)(5) (1992). However, the definition of passive and active income for real estate investment trusts is *sui generis* (with passive income a substantially broader concept), including a history of treating hotel-type income's active and passive components as severable. Treas. Reg. § 1.856-4(a) (as enacted in 1962 by T.D. 6598, 1962-1 C.B. 105). *See infra* Part IV.A.

- ⁵ Separated into distinct components, the active real property of a destination gaming resort comprises those portions of the property where predominantly active business is conducted, such as the gaming floor. Given the luxury market, personal service and short-term occupancy focused nature of the business, there are few or no areas where the business derived is exclusively passive in nature. For instance, the hotel tower is predominantly passive real property, but significant active business is also realized there, such as personal services like room service. Some destination gaming resorts realize exclusively passive business in their retail areas, when they hire sufficiently unrelated management, supply only customary general services and resort to triple net lease arrangements. *See infra* Part IV.A.
- ⁶ See, e.g., MGM Mirage Ann. Rep. 29-30 (2008); Wynn Resorts Ann. Rep. 43-47 (2008). Cf., Kisang Ryu & Shawn Jang, Performance Measurement Through Cash Flow Ratios and Traditional Ratios: A Comparison of Commercial and Casino Hotel Companies, 12 J. Hospitality Fin. Mgmt 15, at 19 (2004).
- ⁷ Businesses also use asset-backed debt financing arrangements for real property capital. However, customary covenants and excessive debt loads limit the firm's capacity to respond to changing economic circumstances or increased competition and may expose the firm to high interest expenses. Still, it may be tax advantageous to capitalize with reasonable levels of debt, as opposed to purely shareholder capital because only debt supports interest deductions. For these reasons, it is likely that operators use a blend of asset-backed debt and, when traded, issues of stock or debt securities.
- ⁸ Businesses organized as corporations, limited liability companies, partnerships, or trusts may become a public company (becoming a business readily traded on a secondary market or traded on an established securities market); doing so subjects them to taxation as if they were Subchapter "C" corporations under special rules that convert non-corporate status into corporate status for tax purposes. This special rule applies unless the publicly traded business' income is overwhelmingly passive in nature. 26 U.S.C. §§ 7704(a), (c)-(d) (2006 & Supp. II 2008), 301, 11(a), 311, 336 (2006), 1362(b)(1)(A)-(B) (2006 & Supp. I 2007).

because it imposes double taxation on firm income. In many cases, the drive to become publicly traded is substantially attributable to the passive real property's demand for capital investment, which greatly exceeds the capital investment in active real property. In this way, a destination gaming resort's demand for capital investment in passive real property pushes it into becoming publicly traded, dragging all of its income, active and passive, into tax inefficient Subchapter "C." Clearly, these businesses find the tax penalty of Subchapter "C" sufficiently offset by the liquidity and otherwise cost-effective access to capital (both debt and equity) available from being traded on a public market.

The consequences of excessive capital investment in real property are widely recognized, even if publicly traded. Like other capital-intensive industries, destination gaming resorts are aware of the benefits of monetizing their capital investment and aim to reduce the amount of capital trapped in the real property necessary to their business operations, particularly their cash intensive passive real property. However, destination gaming resorts have not developed wholly effective strategies in this regard.¹² This is likely due to the sheer scale of these businesses, the fear of losing control over assets critical to business success, and the considerable regulatory overlay these businesses are subject

⁹ See infra note 29. Additionally, the long-term preferential rate for individuals is unavailable to Subchapter "C" corporations; they are taxed on capital gains at regular corporate rates. 26 U.S.C. §§ 1(h) (2006 & Supp. II 2008), 11 (2006).

¹⁰ See supra note 7. The areas comprising the passive real property are substantially larger than the areas comprising the active real property (compare, for example, the gross floor area of the hotel tower and the gaming floor). The use and allocation of space at gaming properties is tightly controlled, commonly forcing substantial additional investment in passive real property for even modest increases in core active real property. Additional passive real property requires additional capital investment, but is potentially resolved by directly accessing the public markets for cost effective replacement capital (excepting the tax efficiency cost). Compare, e.g., N.J. STAT. ANN. §§ 5:12-80.1(b), (c), 5:12-80.2 (a), (b) (West 2011), with N.J. STAT. ANN. §§ 5:12-83(a), (c)-(d), 5:12-82(b)(1) (West 2011). Cf., James O'Donnel, Seoki Lee & Wesley S. Roehl, Economics of Scale and the Atlantic City Casino Industry, 1 Int'l CHRIE Conf. Refereed Track (2009), http://scholarworks.umass.edu/cgi/viewcontent.cgi?article=1018&context=jhfm.

¹¹ When stock values are elevated, becoming publicly traded is used as both a capital raising arrangement and a monetization strategy for business founders. Depending on the extent to which founders exit the business and raise capital, the transaction may represent the exchange of private investment in capital intensive real property for public market investment, at the cost of taxation under Subchapter "C" as to all active and passive income.

¹² Although their options are limited by the need to maintain a desired guest experience throughout the resort, they may monetize retail components by selling them for cash. *See, e.g.*, Las Vegas Sands Corp., Registration Statement (Form S-4) 152-153 (June 7, 2005) (describing the sale of the Grand Canal Shoppes retail area at the Venetian Resort, Las Vegas, NV). As an alternative, they may develop condominium-hotels. A condominium hotel is a hotel in which an investor takes title to a specific hotel room but which remains generally available in a resort managed rental pool. *See, e.g.*, Jennifer Shubinski, *Developers Offering a New Kind of Suite Deal With Condo-Hotels*, Las Vegas Sun, Jan. 2, 2006, http://www.lasvegassun.com/news/2006/jan/02/developers-offering-a-new-kind-of-suite-deal-with-/; Mike Schneider, *Hotel Condo is Growing Trend in U.S.*, Las Vegas Sun, June 6, 2005, http://www.lasvegassun.com/news/2005/jun/06/hotel-condo-hybrid-is-growing-trend-in-us/; Michael Corkery, Sara Lin and Ruth Simon, *Rooms With a Bubble View*, Wall St. J., Apr. 5, 2008, http://online.wsj.com/article/SB120735504829291471.html.

Spring 2011] REIT INVESTMENT

to. 13 Notwithstanding that destination gaming resorts sooner or later acquire funding on the public capital markets, the capital-intensive nature of these businesses continues to pose a significant business challenge, particularly when funded with excess debt, and imposes undesirable tax outcomes when it drags the entire business into tax inefficient Subchapter "C." Despite the storied evolution of gaming businesses from modest origins into large enterprises operating destination gaming resorts with direct access to public markets, the massive amount of capital investment now essential to, and trapped within, their underlying and predominantly passive real property poses a significant business challenge. However, the scale of the business and severability of the passive real property may permit novel solutions, including restructuring all or some of their passive real property investment using a real estate investment trust ("REIT") based transaction¹⁴ as part of a broader strategy to avoid being dragged into undesirable Subchapter "C" taxation.

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POTENTIAL USE OF REITS TO MONETIZE DESTINATION GAMING III. RESORT INVESTMENT IN PASSIVE REAL PROPERTY

Technically, REITs are tax corporations through which shareholders derive income from debt and/or equity investments in real property in a passive but federal income tax-efficient manner. Corporations began electing REIT status shortly after the authorizing legislation appeared in 1960. Modeled on mutual funds, REITs originated as a method by which individuals with or without significant assets could invest in real property. ¹⁵ A REIT based transaction is not the only way a destination gaming resort can address, by monetizing, its existing capital investment in real property, but a REIT's access to public markets and inherent tax efficiency make it a presumptively optimal acquirer or joint venture partner. 16 REITs are poised to become an even more attractive structuring option for large real property based businesses for two principal reasons. First, a body of administrative authority suggests that many of the restrictions that make uneconomic REIT involvement in the passive real prop-

¹³ See supra note 12. This article does not consider the effects, if any, of segmenting destination gaming resort real property, assets and income under state and local law, including gaming regulations.

¹⁴ Some experts have proposed that gaming businesses monetize their investment in real property through a REIT involved lease restructuring. See, e.g., Developments, Double or Nothing, Real Estate Portfolio, May/June 2007, http://www.nareit.com/portfoliomag/07 mayjun/dev1.shtml.

¹⁵ See infra note 43.

¹⁶ REITs enjoy inherent acquisitional advantages and tax efficiencies that tolerate their paying premium prices for assets, making them presumptively optimal acquirors or joint venture partners. Differences in tax rates reflecting tax advantages or disadvantages are sometimes priced into an asset's value, by a process economists term tax capitalization. In the case of publicly traded entities (like many REITs), the theory holds that a corporation that is freed from a corporate level tax will exhibit a rise in its share value attributable to the elimination of the corporate level tax expense (since the net return derived from holding its equity increases as a result of the removal of the tax). RICHARD A. MUSGRAVE & PEGGY B. MUS-Grave, Public Finance in Theory and Practice 259-60 (5th ed. 1984). See also Ste-PHEN G. UTZ, TAX POLICY - AN INTRODUCTION AND SURVEY OF THE PRINCIPAL DEBATE 21-22 (1993).

erty of businesses that blend active and passive income can be overcome or managed through partnership based operating structures. ¹⁷ Second, the relative tax efficiency of REIT arrangements is anticipated to double in 2013.¹⁸

REITs enjoy substantial federal income tax advantages compared to other widely available real property investment vehicles. Unlike Subchapter "C" corporations, REITs avoid taxation on their distributed earnings. ¹⁹ In other words, a REIT's income is taxed only to its shareholders, provided it is distributed.20 This contrasts sharply with "C' corporations, which are taxed on their income and whose shareholders are taxed again on their receipt of the after-tax remainder.²¹ When the effective rate of tax applicable to "C" corporations and their shareholders is contrasted with the rate applicable to REIT shareholders under federal income tax provisions applicable to tax year 2010, a REIT investor only pays at his marginal rate.²² Consequently, REIT shareholders in the top marginal bracket pay at a 35% rate on the REIT distribution, ²³ an amount less than the approximately 44% combined rate of the "C" corporation²⁴ and its shareholder (on a qualified dividend²⁵), a tax efficiency difference favoring the REIT by about 10%. However, when the George W. Bush-era tax rate cuts expire, the difference between a REIT investor's rate and the top marginal income tax rate becomes approximately 21%, more than doubling the REIT structure's relative tax efficiency (on dividends).²⁶ These circumstances indicate that destination gaming resort businesses that are already tax pass-throughs should not expect to ameliorate their federal income tax efficiency by accessing

¹⁷ See infra Part IV.C.

¹⁸ See infra note 28.

¹⁹ 26 U.S.C. §§ 11(c)(3) (2006), 857(b)(2)(B) (2006 & Supp. II 2008).

²⁰ Id. §§ 11(c)(3), 561 (2006), 857(b) (2006 & Supp. II 2008).

²¹ *Id.* §§ 11(a), 61(a)(7), 301(a), (c) (2006).

²² Id. §§ 61(a)(7), 11(c)(3) (2006), 857(b) (2006 & Supp. II 2008); Treas. Reg. § 1.857-6(b) (as amended in 1986). In limited cases, REITs issue capital gain dividends that are taxed at the current long term capital gains rate of 15%. 26 U.S.C. §§ 1, 857(b)(3)(B) (2006 & Supp. II 2008).

Id. §§ 1(i)(2) (2006 & Supp. II 2008), 61(a)(7) (2006).

²⁴ Id. § 11(b) (2006).

²⁵ Id. §§ 1(h)(11) (2006 & Supp. II 2008), 61(a)(7) (2006). REIT distributions are generally ineligible for treatment as a 26 U.S.C. § 1(h)(11) (2006 & Supp. II 2008) qualified dividend since a REIT is not taxed as a corporation. Id. § 1(h)(11)(D) (2006 & Supp. II 2008).

²⁶ The George W. Bush era tax cuts arose under the Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836, 107th Cong., Pub. L. No. 107-16, 115 Stat. 38 (2001) (codified as amended in scattered sections of 26 U.S.C.) and were broadened and accelerated under the Jobs and Growth Tax Relief Reconciliation Act, H.R. 2, 108th Cong., Pub. L. No. 108-27, 117 Stat. 752 (2003) (codified as amended in scattered sections of 26 U.S.C.). As enacted, these laws were set to sunset at the end of 2010. H.R. 1836, § 901(a)(1). Together, these enactments reduced individual income tax rates to 10%, 15%, 25%, 28%, 33% and 35%, from 15%, 28%, 31%, 36% and 39.6%, while certain 26 U.S.C. § 1(h)(11) (2006 & Supp. II 2008) qualified dividends became taxed at 5% and 15% (when the provisions sunset, the latter rates are scheduled to return and dividends will once again be taxed as ordinary income at a taxpayer's marginal rate). However, these tax rates were extended until the end of 2012. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, H.R. 4853, 111th Cong., Pub. L. No. 111-312, §§ 101-102, 124 Stat. 3296, 3298-99 (2010). This article does not consider any taxes imposed under the Patient Protection and Affordable Care Act, H.R. 3590, 111th Cong., Pub. L. No. 111-148, 124 Stat. 119 (2010).

REIT tax efficiency as to their passive real property; however when a "C" corporation, or when publicly listed, or about to be publicly listed, a REIT structure may preserve significantly more tax efficient arrangements, as it furthers the monetization of a substantial capital investment in real property.²⁷

Generally, businesses that have invested substantial capital in passive real estate can monetize²⁸ (in the sense of reducing to cash or a liquid near equivalent) their existing investment directly, through a sale-leaseback transaction involving a REIT, or less directly, through a transfer for liquid REIT equity (or its economic equivalent). Fully monetizing a passive real property investment frees up capital and allows them to focus their energy and resources on primary active businesses and assets.²⁹ However, any sale-leaseback or transfer for REIT equity transaction must preserve the viability of any dependent and intertwined active and passive businesses (here, both aspects are essential to the unique experience and luxury atmosphere the resort is predicated on and that is demanded by guests).³⁰ A not-yet-publicly-traded destination gaming resort can monetize its capital investment in real property in a tax efficient manner through a REIT based transaction, preserving for its founders its active business in a tax efficient form instead of forcing a public listing transaction that drags all aspects of the business, passive and active, into taxdisadvantageous Subchapter "C". Moreover, because destination gaming resorts combine separable passive real property and active real property, they represent a unique opportunity for a REIT acquisition.³¹ In theory, a REIT could acquire all or some of the property, leasing it entirely to a sufficiently unrelated gaming operator (hereinafter, an "operator lease"), or it can acquire only its passive real property components, limiting itself to passive business

²⁷ Pass-through entities, such as tax partnerships (including limited liability companies taxed as partnerships), normally enjoy greater tax efficiency than Subchapter "C" corporations, for three principal reasons. First, they are not separate taxpaying entities, which permits them to distribute their earnings without reduction for an entity level tax. See 26 U.S.C. §§ 701, 702, 11(a), 1363(a)-(b), 301(a), (c), 302(e)(5) (2006). Second, they enjoy a preferential rate on their long-term capital gains that is not available to Subchapter "C' corporations. See id. §§ 1(h), 857 (2006 & Supp. II 2008), 11(a) (2006). Third, they are able to allocate tax losses to their equity investors (in contrast to Subchapter "C" corporations, whose losses are isolated within the entity). See id. §§ 705, 302(e)(5), 1363(a), 311(b) (2006), 857 (2006 & Supp. II 2008).

²⁸ Deardorffs' Glossary of International Economics, *Monetize*, http://www-personal.umich. edu/~alandear/glossary/m.html (last visited Jan. 23, 2011).

²⁹ This applies to real property based enterprises whose focus is not developing and repeatedly disposing of real estate.

³⁰ See supra note 14.

³¹ See 26 U.S.C. § 7704(a)-(b) (2006 & Supp. II 2008); Treas. Reg. § 1.7704-1(a)(1) (as amended in 1995); Treas. Reg. § 1.7701(1)-3 (as amended in 2000). They may also be attractive to certain publicly traded partnerships. They are not taxed as "C' corporations (unlike other publicly traded partnerships) but as tax partnerships, provided their income is at least 90% passive under criteria set out in 26 U.S.C. § 7704(c) (2006 & Supp. II 2008). However, if they cannot satisfy the passive income requirement, they are taxed under Subchapter "C'. See id. § 7704(c)-(d) (2006 & Supp. II 2008). Under 26 U.S.C. § 7704(d)(1)-(4) (2006 & Supp. II 2008), permitted passive sources include real property rents as provided in 26 U.S.C. § 856(d)(1)-(2) (2006 & Supp. II 2008) but without regard to the independent contractor rules set out in 26 U.S.C. § 856(d)(7)(C) (2006 & Supp. II 2008). Id. § 7704(c)(3) (2006 & Supp. II 2008). See supra note 10.

from directly supplying accommodation and certain services to guests (hereinafter "direct operation"). Yet, to date, no destination gaming resort business has been restructured to involve a REIT in either way.

The absence of REIT involvement in destination gaming resort businesses is principally attributable to the REIT qualification requirements, and the economic constraints they impose on resorts featuring gaming. Generally, these requirements place strict limits on business structure and operation, as they constrain or eliminate a REIT's ability to engage in active business (forcing REITs to act predominantly as passive investors in real property and to use substantially unrelated suppliers for any active business, aside from a limited amount realizable through taxable subsidiaries³²). As a general matter, the degree to which the REIT qualification rules would burden the acquisition of real property is primarily a function of the amount, and type, of income it would yield. This, in turn, determines whether it can be arranged with direct operation, or whether REIT involvement is limited to an operating lease. For those few properties that combine substantial amounts of separable active and passive business, the potential for a REIT to directly realize their passive components is a function of the amount of active business remaining at the severed passive real property.³³ In these cases, under conventional structuring approaches not involving leases to taxable subsidiaries, direct involvement depends on whether the value of the net active business required to be conducted in taxable subsidiaries would exceed 25% of the value of all REIT assets (after reduction for a de minimis amount of unconstrained active income)³⁴ and whether distributions out of these subsidiaries would cause the REIT to fail certain tests predicated on sufficient passive real property based income.35 If a REIT is unable or unwilling to directly realize these passive business components, its involvement is limited to acquiring the property and acting as lessor to an unrelated operator (such as a through a sale-leaseback). However, where the real property is a hospitality facility with gaming, its passive real property contains significant active business (owing to its personal services intensive qualities).³⁶ Here, the active business remaining at the passive real property could overwhelm these general limits, but even if it would not, special qualification rules preclude isolating gaming property active business in a taxable subsidiary. Furthermore, these special rules prevent REITs from leasing the property to their subsidiaries (which, when available, can filter hotel income to the REIT in tax efficient fashion).³⁷

³² See infra Part IV.A-B. Cf. 26 U.S.C. § 269B (2006) (comparing to stapled entities).

³³ Or, to a lesser extent, whether its passive but not real property based qualifying income exceeds 25% of its gross income. Directly realizable customary services income is effectively unlimited. See infra Part IV.A.

³⁴ 26 U.S.C. § 856(c)(3), (c)(4)(B)(ii), (d)(1)-(2), (d)(7), (l)(1) (2006 & Supp. II 2008). For tax years ending on or before December 31, 2008, the effective limit was 20%. See infra Part IV.A-B and note 153.

³⁵ 26 U.S.C. § 856(c)(3) (2006 & Supp. II 2008).

³⁶ See supra notes 3 and 7. Given its excess of active income, a destination gaming resort cannot directly qualify as a REIT.

³⁷ See 26 U.S.C. § 856(c)(2), (c)(4)(B)(ii), (d)(1)-(2), (d)(7), (d)(9)(D), (1)(1) (2006 & Supp. II 2008). See infra Part IV.A-B.

Spring 2011] REIT INVESTMENT

These limits represent an inherent economic disadvantage requiring the REIT to forgo directly or indirectly realizing the active business remaining at the passive real property, effectively limiting its involvement to an operator lease.³⁸ Moreover, aside from these limits on gaming properties under the REIT tax rules, because the active and passive aspects of a destination gaming resort are dependent and intertwined, introducing an unrelated operator into its passive real property components is undesirable (this limits the REIT's operator lease to a sale-leaseback). However, the relative clarity of administrative pronouncements on the subsidiary partnerships of REITs, combined with longstanding property law, suggests a method through which a REIT may engage in direct operation of the passive real property of a destination gaming resort without introducing economic or business penalties for the REIT or resort. This partnership arrangement is an alternative to customary structures that limit REIT involvement to the sale-leaseback version of operator leases. Consequently both direct operation, using a special partnership arrangement, and the sale leaseback form of operator lease, allow destination gaming resorts to monetize an existing passive real property investment, and permit them to retain the active aspects of their business in tax efficient form without necessarily introducing business disadvantages, results that are unavailable if the business becomes publicly traded as a whole and taxed as a Subchapter "C" corporation.³⁹

These conclusions depend, in many parts, on analogies and inferences drawn from available administrative materials; because REITs are cautious, they typically seek tax rulings before adopting a novel business structure (which supplies a wealth of administrative insight but little precedent). It is important here to emphasize that making an intelligent business decision on whether to consider any REIT involved arrangement depends on integrating business, financial and tax analysis that is necessarily unique to each business.

IV. REIT QUALIFICATION RULES AND THEIR EFFECT ON THE AVAILABILITY OF REIT BASED MONETIZATION TRANSACTIONS

A. REIT Qualification Rules

Technically, a REIT is a corporation, trust, or association that has made a REIT election. 40 To validly make and maintain this election, the entity must satisfy numerous requirements.⁴¹ An entity making a REIT election must satisfy the following organizational tests: (i) the entity must be organized as a

³⁸ See infra Part IV.B.

³⁹ In cases where the destination gaming resort is already publicly traded, with some adjustments, the arrangement might also serve to offset a sunken capital investment in passive real property as a prelude to a leveraged buy-out or other "going private" transaction as to its active business aspects. For planned destination gaming resort businesses, this arrangement might serve as the basis for a co-venture through which the REIT supplied needed capital investment in passive real property, allowing the destination gaming resort business to remain privately held in tax efficient form.

⁴⁰ 26 U.S.C. § 856(c)(1) (2006 & Supp. II 2008); Treas. Reg. § 1.856-2(b) (as amended in 1981).

⁴¹ Treas. Reg. § 1.856-1(a) (as amended in 1981). The original legislation permitting REIT elections was part of An Act to Amend the Internal Revenue Code With Respect to Excise

corporation, trust, or association; 42 (ii) the entity must be managed by one or more trustee(s) or director(s);⁴³ (iii) the entity must issue transferable shares or certificates;⁴⁴ (iv) the entity must qualify to be taxed as a domestic corporation (determined as if the REIT election was not in effect);⁴⁵ and (v) the entity must have at least one hundred shareholders and cannot be closely held under applicable guidance.⁴⁶ Finally, the organizational tests require that the entity (i) not constitute a financial institution or insurance company for tax purposes, ⁴⁷ (ii) have in effect a valid REIT election, ⁴⁸ and (iii) comply with several REIT specific record-keeping requirements.49

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In addition, the entity must satisfy operational tests, 50 which are tests as to the source and distribution of its income, and as to the amount and nature of its assets. The operational tests require that: (i) at least 75% of the value of the entity's assets constitute real property assets,⁵¹ cash,⁵² cash items,⁵³ or government securities⁵⁴ (hereinafter the "Asset(s) Test");⁵⁵ (ii) no more than 25% of the value of entity's assets constitute securities of any issuer (other than securities permitted under the Assets Test);⁵⁶ (iii) no more than 25% of the value of

Taxes on Cigars, H.R. 10960, 86th Cong., Pub. L. No. 86-779, 74 Stat. 998, 1003-04 (1960) (codified as amended in scattered sections of 26 U.S.C.). H.R. REP. No. 86-2020 (1960).

⁴² 26 U.S.C. § 856(a) (2006 & Supp. II 2008). See also Treas. Reg. § 301.7701-2(b) (as amended in 2009); Treas. Reg. § 301.7701-4 (as amended in 1996).

⁴³ 26 U.S.C. § 856(a)(1) (2006 & Supp. II 2008); Treas. Reg. § 1.856-1(b)(1), (d)(1) (as amended in 1981).

⁴⁴ 26 U.S.C. § 856(a)(2) (2006 & Supp. II 2008); Treas. Reg. § 1.856-1(b)(2), (d)(2) (as amended in 1981).

⁴⁵ 26 U.S.C. § 856(a)(3) (2006 & Supp. II 2008); Treas. Reg. § 1.856-1(b)(3) (as amended in 1981).

⁴⁶ 26 U.S.C. § 856(a)(5)-(6), (h) (2006 & Supp. II 2008); Treas. Reg. § 1.856-1(b)(6)-(7), (d)(5) (as amended in 1981). To identify REITs with excessively concentrated ownership, the rules incorporate (after modification) the personal holding company test of 26 U.S.C. § 542(a)(2) (2006) and the stock attribution rules of 26 U.S.C. §§ 544 (2006) and 856(h)(1) (2006 & Supp. II 2008) [hereinafter "The 5-50 Rule"].

⁴⁷ Id. § 856(a)(4) (2006 & Supp. II 2008); Treas. Reg. § 1.856-1(b)(5) (as amended in 1981).

 $^{^{48}}$ 26 U.S.C. § 856(a)(2), (c)(1), (g) (2006 & Supp. II 2008). See Treas. Reg. § 1.856-8 (1981).

⁴⁹ See 26 U.S.C. §§ 856(f)(1), (k), 857(f) (2006 & Supp. II 2008); Treas. Reg. § 1.857-8 (as amended in 1981).

⁵⁰ 26 U.S.C. § 856(a)(7), (c) (2006 & Supp. II 2008).

⁵¹ *Id.* § 856(c)(4)(A), (c)(5)(A)-(B) (2006 & Supp. II 2008); Treas. Reg. § 1.856-2(d) (as amended in 1981); Treas. Reg. § 1.856-3(a)-(b), (d) (as amended in 1992).

⁵² 26 U.S.C. § 856(c)(4)(A) (2006 & Supp. II 2008). See also Rev. Rul. 72-7,1 1972-1 C.B. 99; Rev. Rul. 77-59, 1977-1 C.B. 196.

⁵³ Such as non-purchased receivables and certificates of deposit. 26 U.S.C. § 856(c)(4)(A) (2006 & Supp. II 2008); Treas. Reg. § 1.856-2(d)(3) (as amended in 1981).

⁵⁴ 26 U.S.C. § 856(c)(4)(A), (c)(5)(F) (2006 & Supp. II 2008); 15 U.S.C. § 80a-1 (2006); 15 U.S.C.A. § 80a-2(16) (West, Westlaw through Pub. L. No. 111-203 effective July 21,

⁵⁵ 26 U.S.C. § 856(a)(7), (c)(4)(A) (2006 & Supp. II 2008).

⁵⁶ Id. § 856(c)(4)(B)(i), (c)(5)(F) (2006 & Supp. II 2008). The term securities does not include interests in real property within the definition of 26 U.S.C. § 856 (2006 & Supp. II 2008), including partnership interests, securities held in partnership solution (where sufficient passive real property assets and income exist), and certain partnership issued securities

REIT INVESTMENT

unknown

57

8:40

the entity's assets consists of the securities of its taxable REIT subsidiaries;⁵⁷ (iv) the entity does not have more than 5% of the value of its total assets in securities issued by any one issuer (not counting any securities of taxable REIT subsidiaries, government securities, or securities includable in the Assets Test);⁵⁸ (v) the entity does not own 10% or more of the value of the total outstanding securities issued by any one issuer (not counting the value of any taxable REIT subsidiary securities owned and not counting government securities),⁵⁹ and (vi) the entity does not hold more than 10% of the total voting power of the outstanding securities of any one issuer (not counting those of any taxable REIT subsidiaries or government securities, and not counting securities that are includable in the Assets Test).⁶⁰

Moreover, the operational tests require that: (i) at least 75% percent of the entity's gross taxable income⁶¹ consists of rents from real property,⁶² gains from dispositions of real property,⁶³ distributions from other REITs,⁶⁴ interest on obligations secured by land, interests in land or improvements to land,⁶⁵ income from foreclosure property,⁶⁶ or other specified income⁶⁷ (hereinafter the "75% Income Test"); and (ii) at least 95% of the entity's gross taxable income consists of rents from real property,⁶⁸ gains from real property dispositions,⁶⁹ distributions from other REITs (such as dividends),⁷⁰ interest,⁷¹ income from foreclosure property,⁷² dividends,⁷³ and gains from stock and security

held (but limited to the extent of the REITs' interest in the partnership). *Id.* § 856(m)(3)-(4) (2006 & Supp. II 2008); Treas. Reg. § 1.856-3(e) (as amended in 1992).

 $^{^{57}}$ 26 U.S.C. § 856(c)(4)(B)(ii) (2006 & Supp. II 2008). "Securities" for this purpose is defined by reference to 26 U.S.C. § 856(c)(5)(F) (2006 & Supp. II 2008).

⁵⁸ *Id.* § 856(c)(4)(B)(iii), (c)(4)(B)(iii)(I) (2006 & Supp. II 2008).

⁵⁹ *Id.* § 856(c)(4)(B)(iii)(III) (2006 & Supp. II 2008). *See also* I.R.S. Priv. Ltr. Rul. 2002-34-054 (Aug. 23, 2002). Value for purposes of this rule is determined without regard to whether the securities have voting rights. 26 U.S.C. § 856(c)(4)(B)(iii)(III) (2006 & Supp. II 2008). *Cf.*, S. Rep. No. 106-201, at 57 (1999).

^{60 26} U.S.C. § 856(c)(4)(B)(iii)(II) (2006 & Supp. II 2008).

⁶¹ Excluding income from certain prohibited transactions. 26 U.S.C. § 856(c)(3) (2006 & Supp. II 2008); Treas. Reg. § 1.856-2(c) (as amended in 1981).

⁶² 26 U.S.C. § 856(c)(3)(A) (2006 & Supp. II 2008). Rents from real property are defined in 26 U.S.C. § 856(d) (2006 & Supp. II 2008).

⁶³ Including gains from disposing of certain interests in real property (other than inventory) and interests in mortgages, or gains from the sale of the shares of other REITs. *Id.* § 856(c)(3)(C) (2006 & Supp. II 2008).

⁶⁴ Only dividends from other REITs constitute qualifying income for purposes of the 75% Income Test. *Id.* § 856(c)(3)(D) (2006 & Supp. II 2008).

⁶⁵ *Id.* § 856(c)(3)(F) (2006 & Supp. II 2008).

⁶⁶ *Id*.

⁶⁷ These other sources are abatements or refunds of property taxes, certain loan commitment fees, gains on real property from the prohibited transactions safe-harbor, and qualified temporary investment income, as permitted by 26 U.S.C. § 856(c)(3)(E), (c)(3)(G)-(I), (c)(5)(D) (2006 & Supp. II 2008).

⁶⁸ Id. § 856(c)(2)(C), (d)(1) (2006 & Supp. II 2008).

⁶⁹ *Id.* § 856(c)(2)(D) (2006 & Supp. II 2008).

⁷⁰ *Id.* § 856(c)(2)(A) (2006 & Supp. II 2008).

 $^{^{71}}$ Id. § 856(c)(2)(B) (2006 & Supp. II 2008); Treas. Reg. § 1.856-5(a) (as amended in 1981).

⁷² 26 U.S.C. § 856(c)(2)(F) (2006 & Supp. II 2008).

58

dispositions⁷⁴ (hereinafter the "95% Income Test").⁷⁵ Finally, the operational tests require that the entity distribute at least 90% of its REIT taxable income each year and 90% of its net after tax foreclosure property income if it has any (after reduction for any excess non-cash income)⁷⁶ and preclude the entity from holding any earnings and profits that were accumulated in a year it was not qualified as a REIT.77

A key requirement is the definition of real property assets for the purposes of the Assets Test. The term includes real property, 78 mortgages on land and improvements, ⁷⁹ shares of stock and certificates of beneficial interest in other REITs, certain temporary investments,80 and certain interests in real estate mortgage investments conduits.⁸¹ Importantly, real property assets are deemed to include a REIT's proportionate interest in real property owned by partnerships in which the REIT is a partner.⁸² For purposes of the Assets Test, all interests in real estate are real property assets; 83 accordingly, fee ownership, coownership, leaseholds and analogues thereto, and options to purchase land or improvements to land or leaseholds count as real property in determining the satisfaction of the Assets Test.⁸⁴ Although real property assets are deemed to include inherently permanent structures⁸⁵ and building structural components, 86 accessories to the operation of a business are not real property for

⁷³ Dividends from any source qualify for purposes of the 95% Income Test. Id. § 856(c)(2)(A), (c)(3)(D) (2006 & Supp. II 2008).

⁷⁴ The stock, securities and real property disposed of cannot constitute inventory property within 26 U.S.C. § 1221(a)(1) (2006). Id. § 856(c)(2)(D) (2006 & Supp. II 2008).

⁷⁵ *Id.* § 856(c)(2) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4 (as amended in 1981). Other qualifying sources include abatements and refunds of property taxes, gains on real property within a prohibited transactions safe harbor, and loan commitment fees. 26 U.S.C. § 856(c)(2)(E), (c)(2)(G)-(H) (2006 & Supp. II 2008). Certain mineral royalty income earned by timber REITs is treated as qualifying income for purposes of the 95% Income Test. Id. § 856(c)(2)(I), (c)(5)(I) (2006 & Supp. II 2008). The remaining 5% of REIT income is unrestricted; it may be passive or active, and based on real property or non-real property assets. See infra note 100.

⁷⁶ 26 U.S.C. § 857(a)(1)(A) (2006 & Supp. II 2008).

⁷⁷ Id. § 857(a)(2)(B) (2006 & Supp. II 2008); Treas. Reg. § 1.857-11 (as amended in 2000).

⁷⁸ 26 U.S.C. § 856(c)(5)(B) (2006 & Supp. II 2008); Treas. Reg. § 1.856-3(c)-(d), (f) (as amended in 1992). These are real property interests such as leaseholds, land, improvements and certain building components. The phrase also includes co-ownership interests but does not include oil or gas royalty interests. 26 U.S.C. § 856(c)(5)(C) (2006 & Supp. II 2008).

⁷⁹ Id. § 856(c)(5)(B) (2006 & Supp. II 2008); Rev. Rul. 76-101, 1976-1 C.B. 186; Rev. Rul. 77-459, 1977-2 C.B. 239.

^{80 26} U.S.C. § 856(c)(5)(C)-(D)(ii) (2006 & Supp. II 2008).

⁸¹ Id. §§ 856(c)(5)(C)-(D) (2006 & Supp. II 2008), 860A-860G (2006).

⁸² Treas. Reg. § 1.856-3(g). See also Rev. Proc. 2003-65, 2003-32 I.R.B. 336; I.R.S. Priv. Ltr. Rul. 2002-34-054 (Aug. 23, 2002). See infra Part IV.C.

^{83 26} U.S.C. § 856(c)(5)(B), (D) (2006 & Supp. II 2008).

⁸⁴ Id. § 856(c)(5)(B)-(C) (2006 & Supp. II 2008); Treas. Reg. § 1.856-3(c). See also I.R.S. Priv. Ltr. Rul. 2000-39-017 (Sept. 29, 2000); Rev. Rul. 64-75, 1964-1 C.B. 228.

⁸⁵ Treas. Reg. § 1.856-3(d). For example, the IRS has ruled that billboards are inherently permanent structures. Rev. Rul. 80-151, 1980-1 C.B. 7.

⁸⁶ Treas. Reg. § 1.856-3(d). Cf., Treas. Reg. § 1.856-6(b)(2) (as amended in 2001). See also I.R.S. Priv. Ltr. Rul. 2000-27-034 (July 7, 2000).

REIT INVESTMENT

unknown

59

purposes of the Assets Test.⁸⁷ Accordingly, hotel furnishings and movable gaming equipment do not constitute real property assets for purposes of the Assets Test.88

There is significant complexity within the 75% Income Test and 95% Income Test. 89 Equity or property holding REITs derive nearly all their qualifying income from their Internal Revenue Code (hereinafter "IRC") § 856(d)(1)(A)⁹⁰ rents (hereinafter "real property rents"), deriving substantially less qualifying income from charges for services that are customarily furnished (with the rental of real property),⁹¹ and amounts received for *de minimis* personal property leases. 92 However, the definition of real property rents interacts with a rule that excludes any impermissible tenant services income within IRC § 856(d)(2)(C) (hereinafter "impermissible tenant services income"). 93 This limits qualifying real property rents to:

• Gross amounts⁹⁴ received for the use of, or right to use, the REIT's real property⁹⁵ (hereinafter "real property payments") where no services are provided;

⁸⁷ Even if a structure or component is a fixture for local law purposes, because local law definitions of real property interests are not controlling. Instead, federal tax law definitions control what constitutes a real property asset, for purposes of 26 U.S.C. § 856(c) (2006 & Supp. II 2008). Treas. Reg. § 1.856-3(d); I.R.S. Priv. Ltr. Rul. 1999-04-019 (Jan. 29, 1999). 88 See Treas. Reg. § 1.856-3(d). See also I.R.S. Priv. Ltr. Rul. 2008-40-028 (Oct. 3, 2008). Cf., former Treas. Reg. § 1.856-4(a) (1962).

²⁶ U.S.C. § 856(c)(2)-(3) (2006 & Supp. II 2008), respectively.

⁹⁰ Id. § 856(d)(1)(A) (2006 & Supp. II 2008).

⁹¹ Id. § 856(d)(1)(B) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(1) (as amended in 1981).

⁹² 26 U.S.C. § 856(d)(1)(C) (2006 & Supp. II 2008).

⁹³ Id. § 856(d)(2)(C) (2006 & Supp. II 2008). As defined in 26 U.S.C. § 856(d)(7)(A) (2006 & Supp. II 2008). The income of a REIT from services (including directly realized services customarily furnished under 26 U.S.C. § 856(d)(1)(B) (2006 & Supp. II 2008)), and from the operation or management of real property, constitutes impermissible tenant services income within 26 U.S.C. § 856(d)(2)(C), (d)(7)(A) (2006 & Supp. II 2008). Impermissible tenant services income is included in the REIT's total gross income for purposes of applying the 75% Income Test and the 95% Income Test, but is not treated as qualifying income. *Id.* § 856(d)(7)(E) (2006 & Supp. II 2008). However, income from services furnished using taxable REIT subsidiary arrangements, services furnished using independent contractor arrangements, and from directly provided customary services that do not give rise to unrelated business taxable income are excluded from impermissible tenant services income. Id. § 856(d)(2)(C), (d)(7)(A), (d)(7)(C) (2006 & Supp. II 2008). See generally I.R.S. Priv. Ltr. Rul. 94-24-033 (June 17, 1994). Impermissible tenant services income is determined on a property-by-property basis (not a lease-by-lease basis). Rev. Rul. 98-60, 1998-2 C.B. 749; I.R.S. Priv. Ltr. Rul. 2000-39-017 (Aug. 29, 2000).

⁹⁴ Income from contractual shares in the income or profits of REIT lessees is non-qualifying, but generally a REIT derives qualifying rent when calculated as a percentage of gross sales or gross receipts. 26 U.S.C. § 856(d)(2)(A) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(3) (as amended in 1981).

^{95 26} U.S.C. § 856(d)(1)(A) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(a). These rules link REIT gross income to the use of (and transfer of rights in connection with) the REIT's real property ("the term 'rents from real property' means, generally, the gross amount received for the use of, or the right to use, real property of the [REIT]"). Treas. Reg. § 1.856-4(a) (emphasis added). Fixed easement and license fees have been held to qualify as real property rents. I.R.S. Priv. Ltr. Rul. 1999-08-023 (Feb. 26, 1999) (with customary services supplied by independent contractors). Cf., I.R.S. Priv. Ltr. Rul. 2000-41-024 (Oct. 13,

UNLV GAMING LAW JOURNAL

unknown

[Vol. 2:47

- Gross amounts from real property payments that include a de minimis lease of personal property (including amounts received for the de minimis personal property lease);96
- Gross amounts from real property payments where the REIT directly provides non-customary services to tenants or property users but whose amount⁹⁷ remains within a 1% de minimis exception (but all such de minimis services based income is non-qualifying);⁹⁸
- Gross amounts from real property payments where the REIT directly provides customary services which do not fall within the exception permitting those services that would not give rise to unrelated business taxable income⁹⁹ but do not exceed a 1% de minimis limit¹⁰⁰ (but all such de minimis services income is non-qualifying);¹⁰¹
- Gross amounts from real property payments where services are delivered by a qualifying independent contractor (and only charges from customary services are qualifying);¹⁰²
- Gross amounts received from real property payments where customary or non-customary services are delivered by a taxable REIT subsidiary 103 (not the REIT); and,
- Gross amounts received by the REIT for directly providing customary services (but only if received in connection with real property payments

2000) (REIT generated qualifying real property rents from rooftop lease and license fees). See infra note 123.

⁹⁶ 26 U.S.C. § 856(d)(1)(A), (C) (2006 & Supp. II 2008). Consequently, a REIT cannot lease more than a de minimis amount of personal property, without tainting some of the income as non-qualifying. To qualify for the de minimis exception, the personal property lease must be made in connection with a lease of the real property, and the personal property component of lease income cannot exceed 15% of total lease income. Id. § 856(d)(1)(C) (2006 & Supp. II 2008). Cf., H.R. Rep. No. 94-658, at 366 (1975).

97 Together with all other amounts of impermissible tenant services income at the property. See supra note 95.

⁹⁸ The *de minimis* exception permits REITs that directly deliver *de minimis* services to nonetheless qualify the income derived from a lease of the real property as qualifying rents for purposes of 26 U.S.C. § 856(d)(1) (2006 & Supp. II 2008), under 26 U.S.C. § 856(d)(7)(A)-(B) (2006 & Supp. II 2008). H.R. Rep. No. 105-148, at 604 (1997). The de minimis rule effectively inoculates qualifying income derived from a property where services income (not otherwise excepted from constituting impermissible tenant services income) is less than 1% of all amounts received or accrued by the REIT at the property. However, for purposes of calculating the 1% limit, the amount deemed received as impermissible tenant services income is not less than 150% of the REIT's direct cost in furnishing the service. 26 U.S.C. § 856(d)(7)(D) (2006 & Supp. II 2008); I.R.S. Priv. Ltr. Rul. 2001-06-016 (Nov. 3, 2000).

⁹⁹ 26 U.S.C. § 856(d)(2)(C), (d)(7)(A)(1), (d)(7)(B) (2006 & Supp. II 2008). See supra note 100.

¹⁰¹ 26 U.S.C. § 856(d)(1)(A)-(B), (d)(2)(C), (d)(7)(A)-(C)(ii) (2006 & Supp. II 2008).

¹⁰² Id. § 856(d)(1)(A)-(B), (d)(7)(C)(i) (2006 & Supp. II 2008). Cf., Treas. Reg. § 1.856-4(a), (b)(1). See also I.R.S. Priv. Ltr. Rul. 93-08-013 (Feb. 26, 1993).

¹⁰³ 26 U.S.C. § 856(d)(7)(C)(i) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(a) (predating statutory changes that permit services delivered by taxable REIT subsidiaries).

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¹⁰⁰ See supra note 95.

REIT INVESTMENT

unknown

61

and within an exception permitting services that do not give rise to unrelated business taxable income). 104

What constitutes a customary service is determined by reference to the services that are customary in the real property's geographic area (looking to similar class properties). 105 Typically, when buildings supply customary services, they provide heat, light, water, air conditioning, general maintenance and janitorial services, elevators, recreational facilities, laundry facilities, or security services. 106 Because destination gaming resorts are located in unique markets where comparable class gaming properties normally supply extensive services, it is likely that many services found at destination gaming resorts will yield significant customary service qualifying income (if delivered using an independent contractor, and in limited cases, the REIT itself).

Qualifying real property rents are mostly derived from the consideration received from unrelated parties for the transfer of leaseholds or other rights respecting the REIT's real property assets 107 (directly, and, as detailed below, through its subsidiary partnerships), together with the consideration received for providing a limited type and value of services, in limited ways, to tenants or users of the REIT's real property. 108 As detailed above, if a REIT directly supplies customary services, the REIT generates impermissible tenant services income unless the services would be excluded from unrelated business taxable income under IRC § 512(b)(3).¹⁰⁹ For purposes of the rules, IRC § 512(b)(3)¹¹⁰ provides that its definition of rent is excluded unrelated business

¹⁰⁴ 26 U.S.C. § 856(d)(1)(B), (d)(2)(C), (d)(7)(A), (d)(7)(C)(ii) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(1). See also 26 U.S.C.A. § 512(b) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010); 26 U.S.C. § 511(a)(2) (2006); I.R.S. Priv. Ltr. Rul. 96-40-007 (Oct. 4, 1996).

¹⁰⁵ Services rendered to the tenants of a particular building are customary if, in the geographic market in which the building is located, tenants in buildings of similar class are also customarily supplied with the service. Treas. Reg. § 1.856-4(b)(1); S. Rep. No. 94-938, at 474 (1976). Cf., H.R. Rep. No. 105-148, at 601-602 (1997).

¹⁰⁶ Treas. Reg. § 1.856-4(b)(1). Furnishing heat and light; utilities; repairs and maintenance; cleaning public entrances, exits, stairwells, and lobbies; certain telecommunication, cable television and satellite television; parking; marketing and promotion; and the collection of trash or janitorial services are generally customary services not deemed rendered to a particular occupant or user. Id.; I.R.S. Priv. Ltr. Rul. 2003-20-023 (May 16, 2003); I.R.S. Priv. Ltr. Rul. 98-35-013 (Aug. 28, 1998); I.R.S. Priv. Ltr. Rul. 98-50-009 (Dec. 11, 1998). ¹⁰⁷ 26 U.S.C. § 856(d)(1)(A) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(a). See infra note 97.

¹⁰⁸ 26 U.S.C. § 856(d)(1)(A), (d)(2)(C), (d)(7)(C)(i) (2006 & Supp. II 2008).

¹⁰⁹ 26 U.S.C.A. § 512(b)(3) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010). If it were received by a 26 U.S.C. § 511(a)(2) (2006) organization. 26 U.S.C. § 856(d)(7)(C)(ii) (2006 & Supp. II 2008). For instance, leasing facilities without services, and for a fixed fee, to third party users, generates rent excluded from unrelated business taxable income. Rev. Rul. 80-297, 1980-2 C.B. 196.

¹¹⁰ 26 U.S.C.A. § 512(b)(3) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010). Because 26 U.S.C. § 856(d) (2006 & Supp. II 2008) and 26 U.S.C.A. § 512(b)(3) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010) use substantially similar terms, their definitions of rent are often treated as interchangeable. However, rent for purposes of 26 U.S.C. § 856(d) (2006 & Supp. II 2008) is broader than rent for purposes of 26 U.S.C.A. § 512(b)(3) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010) because only the former includes customary services amounts. See infra note 126.

UNLV GAMING LAW JOURNAL

unknown

[Vol. 2:47

taxable income. 111 Here, rent 112 includes payments for use or occupancy and for services that are usually or customarily supplied with use or occupancy. A payment is no longer excepted rent if any services supplied are unusual or noncustomary because rent does not include payments for services rendered to an occupant (or any payment received for the use or occupancy of rooms where services are also provided to occupants). However, services are only deemed provided to an occupant when they are primarily for the occupant's convenience and are not the type of services usually supplied in connection with the rental of rooms for occupancy only. 114 Income from services supplied in hotels, apartment hotels, or motels is not exempt from unrelated business taxable income, unless the services are so usual and general that they are not deemed rendered to any particular occupant. 115 Accordingly, directly supplying services like foodservice or housekeeping is so personal and beyond merely supplying a room that, even if a customary service for purposes of IRC § 856(d)(1)(B), it must be supplied by an independent contractor or taxable REIT subsidiary. 116 In contrast, furnishing general services, such as heat and light, cleaning public entrances, exits, stairwells, and lobbies, and collecting trash are not services deemed rendered to an occupant. 117 Provided customarily, a REIT can directly supply these general services.

A REIT's proportionate share of the income of a partnership in which it owns an interest is deemed earned by the REIT; consequently, a partnership's earnings that constitute qualifying real property rents will be deemed those of the REIT, to the extent of its proportionate share. Here, partnership-derived income retains the character it had in partnership solution when deemed realized by the REIT. If a partnership derives non-qualifying income (including impermissible tenant services income), the REIT will be deemed to derive it to

¹¹¹ 26 U.S.C.A. § 512(b)(3) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010).

¹¹³ Treas. Reg. § 1.512(b)-1(c)(5) (as amended in 1992); H.R. Rep. No. 99-841, at 216 (1986) (Conf. Rep.). *See infra* note 126.

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¹¹² *Id.*; Treas. Reg. § 1.512(b)-1(c)(5) (1958).

Treas. Reg. § 1.512(b)-1(c)(5) (as amended in 1992). What is a usual service is determined by the underlying property and its geographic location. *Cf.*, I.R.S. Priv. Ltr. Rul. 90-14-022 (Jan. 2, 1990).

¹¹⁵ Treas. Reg. § 1.512(b)-1(c)(1),(5); 26 U.S.C. § 856(d)(7)(C) (2006 & Supp. II 2008). A REIT may generally supply services deemed rendered to a particular occupant through a taxable REIT subsidiary or independent contractor. *Id.* § 856(d)(7)(C)(i) (2006 & Supp. II 2008).

¹¹⁶ Treas. Reg. § 1.512(b)-1(c)(1) (as amended in 1992); Rev. Rul. 69-69, 1969-1 C.B. 159. Supplying substantial services to a user "beyond those . . . rendered in connection with the rental of space for occupancy only[,]" for a particular user's convenience, in connection with a real property lease, is not exempt from unrelated business taxable income. Rev. Rul. 80-298, 1980-2 C.B. 197; *See also* Rev. Rul. 76-402, 1976-2 C.B. 177.

 ¹¹⁷ I.R.S. Priv. Ltr. Rul. 2003-20-023 (May 16, 2003); Rev. Rul. 69-178, 1969-1 C.B. 158;
 I.R.S. Priv. Ltr. Rul. 2003-20-023 (May 16, 2003); I.R.S. Priv. Ltr. Rul. 90-14-022 (Apr. 6, 1990); I.R.S. Priv. Ltr. Rul. 93-40-056 (Oct. 8, 1993); H.R. Rep. No. 99-841, at 220-221 (1986) (Conf. Rep.).

¹¹⁸ Treas. Reg. § 1.856-3(g) (as amended in 1992). *See also* I.R.S. Priv. Ltr. Rul. 96-13-019 (Mar. 29, 1996); I.R.S. Priv. Ltr. Rul. 2003-10-014 (Mar. 7, 2003).

¹¹⁹ Treas. Reg. § 1.856-3(g). *See also* I.R.S. Priv. Ltr. Rul. 96-13-019 (Mar. 29, 1996); I.R.S. Priv. Ltr. Rul. 2002-34-054 (Aug. 23, 2002); 26 U.S.C. § 704(b)-(c) (2006).

63

8:40

the extent of its proportionate share (not its share under any allocation provision of a partnership agreement). 120

Despite the historic acceptance of the passive components of hotel income ¹²¹ and the persistently broad definition of real property rents (not limited to leaseholds and without a minimum period of use or possession ¹²²), in one administrative ruling there is a suggestion that amounts received for short-term occupancy could generate non-qualifying income. This risk appears to be greatest when stays are short, users enjoy extensive services, and the fee paid covers both services and occupancy. ¹²³ This suggestion implies that the Internal Revenue Service may contend that payment for mere occupancy in a destination gaming resort is non-qualifying income. However, it is notable that income is not automatically disqualified as rent (for purposes of IRC § 512(b)(3)¹²⁴) merely because no leasehold exists under local law. ¹²⁵ Under

¹²⁰ Treas. Reg. § 1.856-3(g). *See also* I.R.S. Priv. Ltr. Rul. 96-13-019 (Mar. 29, 1996). *See infra* note 213.

¹²¹ Historically, the definition of real property rents in Treas. Reg. § 1.856-4(a) approved of amounts paid for accommodation as qualifying rent when it adopted an apportionment approach [hereinafter "apportionment approach"] to income from hotel or other furnished accommodation. As originally promulgated, it provided "... the term 'rents from real property' means, generally, the gross amounts received for the use of or the right to use, real property of the [REIT]. Where an amount of rent is received with respect to property consisting of both real and other property, such as a furnished apartment building, hotel or motel, an apportionment of the rent is required. Only that part of the rent attributable to 'real property' shall be included for purposes of the gross income requirements . . ." T.D. 6598, 1962-1 C.B. 92, 105 (emphasis added). Almost twenty years later, during the regulatory overhaul necessitated by the Tax Reform Act of 1976, H.R. 10612, 94th Cong., Pub. L. No. 94-455, 90 Stat. 1520, 1742 (1976), and the Act to Amend the Tariff Schedule of the United States to Permit the Importation of Upholstery Regulators, Upholsterer's Regulating Needles and Upholsterer's Pins Free of Duty [hereinafter "The Upholsterer Act"], H.R. 421, 93d Cong., Pub. L. No. 93-625, 88 Stat. 2108, 2112 (1974), the apportionment approach was excised from Treas. Reg. § 1.856-4(a). T.D. 7767, 1981-1 C.B. 82, 92.

122 See supra note 96. But see 26 U.S.C. § 856(d)(1)(A) (2006 & Supp. II 2008) (referring to "rents from interests in real property") (emphasis added). Neither 26 U.S.C. § 856(d) (2006 & Supp. II 2008) or Treas. Reg. § 1.856-4(a) currently treat income from payments for use or the right to use hotel or furnished apartments as non-qualifying. As a practical matter, the issue is practically moot because the excess of personal services at hotels generally will cause them to fail the passive income tests even if fees for occupancy and customary services are qualifying.

123 Scott L. Semer & Michele J. Alexander, Structuring Real Estate Joint Ventures With Private ReITs A-11, A-15 (BNA Tax Management Portfolio 743) (2009) [hereinafter Semer & Alexander]; I.R.S. Priv. Ltr. Rul. 2008-40-028 (June 17, 2008) ("... whether an arrangement is a lease that produces rents from real property for purposes of section 856(d) or a license or other contract right associated with lodging is determined by examining the substance of the arrangement in its entirety . . ."). The ruling does not specify the source for limiting recognition of lodging rents and does not specify a duration or level of services after which income becomes non-qualifying; instead, the ruling relies on a general proposition (form does not control income tax consequences). Other decisions are consistent with past recognition of hotel and furnished short term accommodation as containing qualifying income. In Rev. Rul. 98-60, 1998-2 C.B. 749, a REIT whose business included a nominal 5% amount of short-term furnished rental apartments (supplied to transient guests under a lease with personal services including housekeeping), the ruling relied on the impermissible tenant services income rules. See infra note 158.

¹²⁴ 26 U.S.C.A. § 512(b)(3) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010); SEMER & ALEXANDER, *supra* note 123 at A-15 n.119 (concluding that rent for pur-

UNLV GAMING LAW JOURNAL

unknown

[Vol. 2:47

this line of reasoning, a REIT risks developing non-qualifying income if it also realizes income from directly supplying substantial personal services to occupants when they, in substance, are paying for purely personal services. ¹²⁶ Consequently, it does not appear that an arrangement is automatically tainted by substantial personal services if the income associated with it is not realized by the REIT or, while realized by the REIT, represents only a nominal amount. While treating the components of hospitality income that are in substance amounts received for use or occupancy of real property as non-qualifying is arguably unsupported by legislative history¹²⁷ and in defiance of the broad def-

poses of 26 U.S.C. § 856(d) (2006 & Supp. II 2008) has at least as broad a meaning as rent for purposes of 26 U.S.C.A. § 512(b) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010)).

¹²⁵ Semer & Alexander, *supra* note 123, at A-15; I.R.S. Gen. Couns. Mem. 34,034 (Feb. 3, 1969) ("... [e]ven if it were to be assumed, however, that no leasehold interests would be created by the arrangements described . . . we do not believe that this circumstance would necessarily preclude the payments from being treated as rents . . . we think that it can properly be inferred that all income items that are received as consideration for granting another party a temporary right to occupy real property will come within the term rents as used in section 512(b)(3) if they also fairly represent what section 543(b)(3) refers to as compensation, however designated, for the use of that property as such, and by the same token do not reflect the rendition of any significant services that are primarily for the convenience of the temporary occupant . . . ") (emphasis added) (quotation marks omitted); Rev. Rul. 69-178, 1969-1 C.B. 158 ("[s]ince the charges in this case are made for the use and occupancy of space in real property and only utilities and janitorial services are provided, the receipts constitute rental income. The fact that the use is only for short periods of time does not destroy the character of the receipts . . .").

¹²⁶ This appears consistent with 26 U.S.C. § 856(d)(7)(C)(ii) (2006 & Supp. II 2008) and in accord with the legislative intent behind An Act to Amend the Internal Revenue Code With Respect to Excise Taxes on Cigars, H.R. 10960, 86th Cong., Pub. L. No. 86-779, 74 Stat. 998, 1003-04 (1960) (codified as amended in scattered sections of 26 U.S.C.) ("... one of the principal purposes of your committee in imposing restrictions on the types of income of a qualifying [REIT] is to be sure that the bulk of *its income* is from passive income sources . . . [t]his interest in restricting the income of the trust to that of a passive nature also accounts for two of the restrictions provided in the definition of [rents] . . .")(emphasis added). H.R. REP. No. 86-2020, at 15 (1960). Implicit in both I.R.S. Gen. Couns. Mem. 34,034 (Feb. 3, 1969) and Rev. Rul. 69-178, 1969-1 C.B. 158 was the fact that, before rental income would be regarded as non-qualifying, it must reflect amounts from supplying significant personal services for particular occupants. See infra notes 158 and 169.

¹²⁷ Nothing in the Tax Reform Act of 1976, H.R. 10612, 94th Cong., Pub. L. No. 94-455, 90 Stat. 1520, 1742 (1976) or the Upholsterer Act, H.R. 421, 93d Cong., Pub. L. No. 93-625, 88 Stat. 2108, 2112 (1974) required or directed the Treasury Department to exclude all hotel income from the definition of qualifying rent. Instead, the Tax Reform Act of 1976, H.R. 10612, derogated the apportionment approach that excluded all amounts received for personal property when it expanded qualifying income to include de minimis personal property. H.R. 10612, § 1604(b), codified at 26 U.S.C. § 856(d)(1)(C) (2006 & Supp. II 2008). H.R. REP. No. 94-658, at 366 (1975); S. REP. No. 94-938, at 474 (1976) (each using furnished apartment buildings as examples). Cf., Treas. Reg. § 1.856-4(b)(2) (1981). Moreover, the amendment of Treas. Reg. § 1.856-4(a) did not claim to derogate the historic treatment of the real property components of hotel or furnished apartment income generally. T.D. 7767, 1981-1 C.B. 82. It would have been easy when revising Treas. Reg. § 1.856-4(a) to merely replace the reference to apportionment with a new de minimis personal property rule, leaving intact the regulation's description of qualifying hotel income. Considering the Congress' apparent satisfaction with the existing approach treating the passive components of hotel income as qualifying, it appears that the drafters may have stripped the entire apportionment approach to avoid confusion with the Upholsterer Act's new foreclosure rules. T.D. 7767,

REIT INVESTMENT

unknown

65

inition of qualifying rents, assuming that hotel rents are rendered non-qualifying in the presence of extensive personal services income, the destination gaming resort may consider a division into separate active and passive business-tiered partnerships. 128 Under the special rules applicable to tiered partnerships, such a division limits the REIT engaging in direct operation to income from short-term use or occupancy and fees from any directly realizable or independent contractor supplied customary services, notwithstanding that guests enjoy extensive services over short stays. In effect, this division purges from the REIT's income the personal service-intensive components of short-stay lodging income that might make it susceptible to deriving, in substance, only personal service income. Importantly, such an arrangement accords with those authorities that treat amounts realized by the REIT for mere occupancy as qualifying income.129

To comply with the limits on qualifying income, but also arrange for property users' access to services that would yield impermissible tenant services income when delivered directly, REITs can use independent contractors. 130 Independent contractors must be distinguished from independent third-party suppliers (hereinafter "independent third party suppliers") who supply services under direct agreements with tenants (without remitting any proceeds to the REIT). 131 To qualify, an independent contractor may not be an employee or agent of the REIT or otherwise be subject to its control. 132 A REIT cannot derive income from its independent contractor. 133 When the service delivered

1981-1 C.B. 82. Cf., S. Rep. No. 93-1357, at 31 (1974). Cf., Treas. Reg. § 1.856-6(b)(2) (1981); Treas. Reg. § 1.856-6(d)(2) (1981). It therefore appears that removing the apportionment approach was the result of limited statutory derogation that expanded the definition of qualifying income but did not interfere with existing recognition that hotel rents can constitute qualifying income, while the broader than strictly necessary revisions to the regulation apparently reflected an effort to avoid confusion with several new hotel-specific foreclosure rules.

¹²⁸ See infra Part IV.C-D. Cf., Rev. Rul. 74-353, 1974-2 C.B. 200 (unrelated co-owner of a REIT realizing services income did not taint the REIT's qualifying income since the REIT derived no direct or indirect income or benefit therefrom).

¹²⁹ 26 U.S.C. § 856(d)(1) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(a) (as amended in 1981); 26 U.S.C. § 856(d)(7) (2006 & Supp. II 2008); Rev. Rul. 98-60, 1998-2 C.B. 749. The arrangement aims to limit the REIT to income that would not constitute unrelated business taxable income, since it derives substantially all its income from the property as fees for mere occupancy and from customary services (not for the benefit of particular occupants). ¹³⁰ 26 U.S.C. § 856(d)(7)(C)(i) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(5) (as amended in 1981); I.R.S. Priv. Ltr. Rul. 94-24-033 (June 17, 1994). Cf. 26 U.S.C. § 856(d)(2)(C), (d)(7)(C)(i) (2006 & Supp. II 2008). See supra note 117.

¹³¹ Treas. Reg. § 1.856-4(b)(5)(i) (1962). See also Rev. Rul. 76-534, 1976-1 C.B. 215; Rev. Rul. 77-23, 1977-1 C.B. 197. Independent third party suppliers are described in I.R.S. Priv. Ltr. Rul. 2000-13-021 (Dec. 15, 1999).

132 Treas. Reg. § 1.856-4(b)(5)(i) (as amended in 1981). See also Rev. Rul. 76-534, 1976-2 C.B. 215; Rev. Rul. 77-23, 1977-1 C.B. 197.

¹³³ 26 U.S.C. § 856(d)(3),(d)(7)(C)(i) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(5)(i) (as amended in 1981). See also Rev. Rul. 66-189, 1966-2 C.B. 277. This is interpreted as barring the REIT from deriving income from the independent contractor other than where the independent contractor acts as a mere conduit for services the REIT can directly provide. I.R.S. Priv. Ltr. Rul. 98-46-019 (Nov. 13, 1998). The adequate compensation requirement aims to prevent REITs from inflating their net rental income. Rev. Rul. 75-52, 1975-1 C.B. 198.

66

is customary, the REIT can bear the cost of the service even though the service is furnished or rendered by the independent contractor (using independent contractor facilities). 134 When the service delivered is non-customary, the independent contractor must bear the complete cost of providing the service, the charge for the service must be separated from rent, received and retained by the independent contractor, and the independent contractor must be adequately compensated. 135

Independent contractor is defined at IRC § 856(d)(3). 136 Under these rules, what constitutes an independent contractor is generally the common law definition (requiring an absence of control by the REIT¹³⁷), supplemented by bright line rules 138 that consider equity ownership. These rules deem an independent contractor to be (i) any person who does not own more than 35% of the shares of the REIT (directly and by attribution of shares); 139 (ii) a corporation in which no more than 35% of the total combined voting power of its stock is owned (directly and by attribution of shares) by one or more persons who own 35% or more of the REIT; ¹⁴⁰ or (iii) a partnership, limited liability company, or other non-corporate entity in which no more than 35% of the interest in its assets or net profits is owned—directly and by attribution of interests—by persons who own 35% or more of the REIT (directly and by attribution of shares). 141 Before the advent of taxable REIT subsidiaries and the rules permitting REITs to directly realize limited customary services income, these restrictions forced REITs to contract with independent firms to manage and operate REIT properties¹⁴² and to deliver services.¹⁴³

After several reforms, it became possible for a REIT to own and control taxable REIT subsidiaries that delivered customary or non-customary personal or general services, 144 without impairing the REIT's qualifying income. 145 Because they permit REITs to realize in after-tax form the income available

¹³⁴ Treas. Reg. § 1.856-4(b)(5)(i). These rules preclude REITs from realizing amounts paid for non-customary services but permit them to collect amounts for customary services, paying themselves the independent contractor.

Id. If the REIT supplied more than de minimis non-customary services using a defective independent contractor arrangement, then all the income from the property is deemed nonqualifying. Id.

¹³⁶ 26 U.S.C. § 856(d)(3) (2006 & Supp. II 2008). Cf., H.R. Rep. No. 105-148, at 602

¹³⁷ 26 U.S.C. § 856(d)(3) (2006 & Supp. II 2008).

¹³⁸ *Id.*; Treas. Reg. § 1.856-4(b)(5)(iii).

¹³⁹ 26 U.S.C. § 856(d)(3)(A), (d)(5) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(5)(iii)(a), (b)(7).

¹⁴⁰ 26 U.S.C. § 856(d)(3)(B), (d)(5) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(5)(iii)(b)(1), (b)(7).

¹⁴¹ 26 U.S.C. § 856(d)(3)(B), (d)(5) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(5)(iii)(b)(2), (b)(7).

¹⁴² Cf., Rev. Rul. 77-23, 1977-1 C.B. 197; Rev. Rul. 76-534, 1976-2 C.B. 215.

The independent contractor rules allow a real property based business to exit its passive real property investment through a public listing transaction involving a REIT election, but permits firm insiders to retain the management business, provided they do not exceed the disqualification threshold. 26 U.S.C. § 856(d)(3), (d)(5) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(5)(iii).

²⁶ U.S.C. § 856(d)(8) (2006 & Supp. II 2008); Ticket to Work and Work Incentives Improvement Act of 1999, H.R. 1180, 106th Cong., Pub. L. No. 106-170, § 542-543, 113

8:40

67

Spring 2011] REIT INVESTMENT

from supplying personal or non-customary services, taxable REIT subsidiaries became the arrangement through which REITs expanded the scope of their business activities and profits, without tainting their qualifying income. 146 Taxable REIT subsidiaries are corporations that are owned, directly or indirectly, by a REIT. They are subject to a corporate level tax and, unlike their REIT parent, do not benefit from the dividends paid deduction. 147 It is important to distinguish taxable REIT subsidiary distributions from the deductible payments they make to the REIT (such as rent); the former are after tax payments, while the latter are effectively pre-tax and generally qualify for the 75% Income Test and 95% Income Test. They are not directly required to make distributions to their REIT parent, but their business relationship must be arm's length. Here, to prevent a REIT from inflating rent or other amounts charged through its taxable REIT subsidiary, effectively extending its tax efficiency to non-qualifying income, a REIT is subject to a confiscatory excise tax on excessive rents it derives from tenants also receiving services from taxable REIT subsidiaries, misallocated deductions in connection with its taxable REIT subsidiaries, and

A subsidiary qualifies as a taxable REIT subsidiary when it is entirely or partially owned by the REIT and both the REIT and the subsidiary make an election.¹⁴⁹ Where a taxable REIT subsidiary itself has subsidiaries, these lower-tier subsidiaries are automatically treated as taxable REIT subsidiaries if the upper-tier taxable REIT subsidiary owns stock or securities amounting to 35% or more of the lower-tier subsidiary's value or vote. 150 However, the REIT qualification rules limit the value of all taxable REIT subsidiaries, relative to total REIT asset value, to no more than 25%. 151 The total value of all the taxable REIT subsidiary securities owned by the REIT (together with the value of all the REIT's non-real property assets) cannot exceed 25% of the value of all REIT assets. 152 A REIT's securities owned in a taxable REIT subsidiary are not real property assets for purposes of the Assets Test. 153 Significantly, a taxable REIT subsidiary's distributions to its REIT parent constitute qualifying passive income for purposes of the 95% Income Test, but not

excess interest amounts charged to its taxable REIT subsidiaries. 148

Stat. 1860, 1941-44 (1999); S. REP. No. 106-201, at 59 (1999); Rev. Rul. 2002-38, 2002-2 C.B. 4. See generally I.R.S. Priv. Ltr. Rul. 2002-34-054 (Aug. 23, 2002).

¹⁴⁵ 26 U.S.C. § 856(d)(1)(A), (d)(2)(C), (d)(7)(A), (d)(8) (2006 & Supp. II 2008). See also I.R.S. Priv. Ltr. Rul. 2002-34-054 (Aug. 23, 2002).

¹⁴⁶ 26 U.S.C. § 856(d)(7)(C)(i) (2006 & Supp. II 2008). A REIT is treated as not rendering or providing any services that its taxable REIT subsidiary does. Id. The rules permit REITs to use a taxable REIT subsidiary to deliver services to non-lessee third parties. Cf., S. Rep. No. 106-201, at 57 (1999).

¹⁴⁷ 26 U.S.C. §§ 857(b)(1) (2006 & Supp. II 2008), 11(a), (c)(3) (2006).

¹⁴⁸ *Id.* § 857(b)(7)(A) (2006 & Supp. II 2008).

¹⁴⁹ *Id.* § 856(l)(1) (2006 & Supp. II 2008).

¹⁵⁰ Id. § 856(1)(2) (2006 & Supp. II 2008). Cf., I.R.S. Priv. Ltr. Rul. 2002-34-054 (Aug. 23,

¹⁵¹ 26 U.S.C. § 856(c)(4)(B)(ii) (2006 & Supp. II 2008). Prior to tax year 2009, the limit was 20%, but it was modified to 25% under § 3041 of the Federal Housing Finance Regulatory Reform Act of 2008, H.R. 6521, 110th Cong., Pub. L. No. 110-289, 122 Stat. 2654, 2900 (2008).

¹⁵² 26 U.S.C. § 856(c)(4)(B)(i) (2006 & Supp. II 2008).

¹⁵³ *Id.* § 856(c)(4)(A) (2006 & Supp. II 2008).

68

the 75% Income Test.¹⁵⁴ These limitations combine to preclude REITs from conducting substantial active businesses through their taxable REIT subsidiaries (or realizing or retaining substantial earnings in taxable REIT subsidiary solution).

A taxable REIT subsidiary can engage in nearly any type of business, including active businesses providing personal services to REIT lessees or third parties that would be problematic if the REIT delivered the service directly. However, enterprises in two specific lines of business cannot qualify as taxable REIT subsidiaries, irrespective of the amount or value of the business. A taxable REIT subsidiary cannot itself operate or manage hotels and cannot franchise or license a service or trademark under which lodging is provided. This special rule applies where the property is a lodging facility (such as a hotel or resort). However, a REIT may lease its hotel property to its taxable REIT subsidiary, and the payments under the lease will constitute qualifying rents (without regard to the restrictions on rental arrangements with related parties

¹⁵⁴ Compare id. § 856(c)(2)(A) (2006 & Supp. II 2008) with id. § 856(c)(3) (2006 & Supp. II 2008). Distributions from a taxable REIT subsidiary must not cause the REIT to lack sufficient passive real estate income for the 75% Income Test. In effect, active business realized in taxable REIT subsidiary solution is converted into qualifying passive income (dividends), for purposes of the 95% Income Test, but remains non-qualifying for the 75% Income Test.

155 A taxable REIT subsidiary may engage in any business activity (excepting only operating, licensing, or managing lodging or health-care facilities) even if the activity is one that, directly conducted by the REIT, would disqualify its income; accordingly, a taxable REIT subsidiary may supply services to the REIT tenants, even where services are non-customary. *Id.* § 856(d)(7)(C)(i), (d)(8), (d)(9) (2006 & Supp. II 2008); S. REP. No. 106-201, at 59 (1999). *See also* Rev. Rul. 2003-86, 2003-2 C.B. 290.

¹⁵⁶ 26 U.S.C. § 856(1)(3) (2006 & Supp. II 2008). A taxable REIT subsidiary may invest in corporations that operate, manage or own a lodging facility (or issue franchises or license a brand name for lodging facilities), provided the taxable REIT subsidiary does not own more than 35% of the lodging corporation's securities. I.R.S. Priv. Ltr. Rul. 2008-15-026 (Apr. 11, 2008). A master lease of a pipeline system, including personal property, to an unrelated operator gave rise to rent from real property for purposes of 26 U.S.C.A. § 512(b)(3) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010). Tax Reform Act of 1976, H.R. 10612, 94th Cong., Pub. L. No. 94-455, 90 Stat. 1520, 1742 (1976); Rev. Rul. 67-218, 1967-2 C.B. 213. Furnishing only facilities under lease to an unrelated lessee who operates real property generates qualifying rent, for purposes of 26 U.S.C.A. § 512(b) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010). Tax Reform Act of 1976, H.R. 10612, 94th Cong., Pub. L. No. 94-455, 90 Stat. 1520, 1742 (1976); Rev. Rul. 80-297, 1980-2 C.B. 196. Accordingly, a REIT can lease a lodging property to a sufficiently unrelated hotel operator using a master lease. There is a significant basis to conclude that a REIT can directly realize qualifying income from guest payments for mere use and occupancy and customary services (provided it does not develop more than de minimis impermissible tenant services income). In Rev. Rul. 98-60, 1998-2 C.B. 749, provided the impermissible tenant services income from short term furnished apartment rentals (inclusive of housekeeping) did not exceed 1% of all amounts, the fees for occupancy remained qualifying rents. Cf., I.R.S. Priv. Ltr. Rul. 94-36-025 (June 8, 1994); I.R.S. Priv. Ltr. Rul. 94-28-033 (Apr. 20, 1994); I.R.S. Priv. Ltr. Rul. 97-51-036 (Dec. 19, 1997) (REIT developed qualifying income in the form of license fees, using an independent contractor). But see I.R.S. Priv. Ltr. Rul. 2008-40-028 (Oct. 3, 2008). See supra notes 95, 97, 123 and 129.

¹⁵⁷ As defined in 26 U.S.C. § 856(d)(9)(D)(ii) (2006 & Supp. II 2008).

REIT INVESTMENT

unknown

69

discussed infra) if the arrangement constitutes a qualified lodging facility. 158 A qualified lodging facility is a lease of a lodging facility without any wagering activity, where the property is operated by an independent contractor¹⁵⁹ (who actively operates lodging facilities for unrelated third parties)¹⁶⁰ and whose rent is set at fair market value level (not tied to net profits). ¹⁶¹ For these purposes, a lodging facility includes hotels, motels, or other properties where more than half of the dwelling units are occupied on a transient basis. 162 The extent of the lodging facility is determined by reference to the amenities and facilities that are customary to facilities of a comparable size and class. 163 However, a qualified lodging facility arrangement is ineffective if (i) the value of the taxable REIT subsidiary's securities would exceed 25% of the REIT's aggregate asset value, (ii) the distributions (other than qualifying rent) would cause the REIT to fail the 75% Income Test, 164 or (iii) there will exist gaming or wagering activities at the property.

A destination gaming resort cannot be leased or contributed by a REIT to a taxable REIT subsidiary, even where the property will be operated by an independent contractor, because the gaming present precludes ever being a qualified lodging facility. Because a gaming resort property could not be isolated in a taxable REIT subsidiary, the REIT could only own the property if all the active income it derived therefrom, together with all its other active REIT income, constituted less than 5% of its gross annual income, and the active income derived from services did not trigger the disqualification of all the property's income as impermissible tenant services income (by remaining de

¹⁵⁸ 26 U.S.C. § 856(d)(8)(B), (d)(9)(D) (2006 & Supp. II 2008); S. Rep. No. 106-201, at 59 (1999); I.R.S. Priv. Ltr. Rul. 2008-25-034 (June 30, 2008). Taxable REIT subsidiaries that lease qualified lodging facilities can bear all the expenses of operating the facility and receive all net revenues, less the independent contractor's fees. I.R.S. Priv. Ltr. Rul. 2008-13-003 (Mar. 28, 2008). A REIT can arrange its relationship with the independent contractor so that it ultimately derives substantially all the net economic return (excepting management fees).

¹⁵⁹ 26 U.S.C. § 856(d)(8)(B), (d)(9)(A)-(B), (d)(9)(D), (l)(3) (2006 & Supp. II 2008).

¹⁶⁰ Id. § 856(d)(9)(A), (d)(9)(F) (2006 & Supp. II 2008). Persons outside the ambit of 26 U.S.C. § 52(a)-(b) (2006). Active operation of lodging facilities can be determined by reference to the standards for assessing active conduct of a trade or business set out in Treas. Reg. § 1.355-3(b)(2)(iii). I.R.S. Priv. Ltr. Rul. 2008-25-034 (June 20, 2008).

¹⁶¹ 26 U.S.C. § 856(d)(9)(D)(i) (2006 & Supp. II 2008); S. Rep. No. 106-201, at 59 (1999); H.R. REP. No. 106-478, at 177-178 (1999) (Conf. Rep.). Under the rules in 26 U.S.C. § 856(d)(9)(A)-(B), (d)(9)(D), (1)(3) (2006 & Supp. II 2008), a subsidiary is not eligible to be a taxable REIT subsidiary if it, itself, operates or manages a lodging facility. Instead, it must resort to an independent contractor.

¹⁶² Id. § 856(d)(9)(D)(ii) (2006 & Supp. II 2008). Cf., Treas. Reg. § 1.48-1(h)(2)(ii) (as amended in 1994); I.R.S. Priv. Ltr. Rul. 2008-40-028 (Oct. 3, 2008); I.R.S. Priv. Ltr. Rul. 2003-20-018 (May 16, 2003).

¹⁶³ 26 U.S.C. § 856(d)(9)(D)(iii) (2006 & Supp. II 2008) ("[t]he term 'lodging facility' includes customary amenities and facilities operated as a part of, or associated with, the lodging facility so long as such amenities and facilities are customary for other properties of a comparable size and class owned by other [unrelated] owners . . . "). Because destination gaming resorts customarily include hotels attached to retail, gaming, restaurant, and entertainment areas, the lodging facility would extend to nearly all of the property, making attempts to sever and isolate gaming areas ineffective.

¹⁶⁴ Because the fair market value rent of the lodging facility reflects all the active and passive income available at the property, this event appears unlikely.

70

minimis).¹⁶⁵ These rules impose an economic penalty in the form of foregoing substantially all active income at the destination gaming resort, even in after-tax form, or foregoing all active and passive income at the property.¹⁶⁶ This limitation appears to be the reason for the absence of REIT involvement in destination gaming resorts.¹⁶⁷

Real property rents do not include any income the REIT derives from lessees that are related corporations, partnerships or limited liability companies (or any other related business arrangement), in which the REIT owns 10% or more of the stock, assets, or profits. For related corporate lessees, the applicable threshold is the ownership of 10% or more of all the voting stock issued, or 10% or more of the value of all its shares issued. 169 For partnership lessees and limited liability company lessees (or other business arrangements acting as lessees), the applicable threshold becomes ownership of 10% or more in the entity's assets or profits.¹⁷⁰ Here, the REIT's ownership interest in a related lessee is determined by reference to IRC § 318 attribution rules. 171 Attribution rules treat stock constructively owned as if actually owned. 172 A modification to the rules for attribution between corporations and shareholders applies which substitutes a lower 10% threshold into the rules of IRC § 318(a)(2)(C) and IRC § 318(a)(3)(C). Transfer of the REIT owns an interest in a lessee that is a partnership, the special rule of IRC § 318(a)(3)(A) applies (but modified to require only a 25% or more interest in the partnership's capital or profits before the partnership's leasing activity becomes attributed to the particular partner).¹⁷⁴ A special exception to these rules applies for rents received through qualifying taxable REIT subsidiaries. 175

Because income attributable to managing or operating real property can constitute impermissible tenant services income, all income from a specific property could become non-qualifying income if a REIT manages or operates, ¹⁷⁶ beyond merely exercising a fiduciary duty to manage the REIT itself. ¹⁷⁷ Like the rules constraining personal services, this limit is potentially

¹⁶⁵ See supra note 100. Cf., H.R. REP. No. 105-148, at 604 (1997).

¹⁶⁶ See Part IV.B.i. See supra note 158.

These limitations do not preclude a REIT from owning and operating (through an independent contractor) real property where its revenues and assets are limited to passive income, such as the fees for mere occupancy and customary services delivered by an independent contractor or not in respect of particular occupants at a hotel. 26 U.S.C. § 856(d)(2)(C), (d)(7)(A) (2006 & Supp. II 2008). *Cf.*, H.R. REP. No. 105-148, at 604 (1997). *See supra* notes 123 and 129. So limited, the REIT would not need to structure its ownership of the lodging property so that it constituted a qualified lodging facility for purposes of 26 U.S.C. § 856(d)(9)(D)(i) (2006 & Supp. II 2008). *See supra* note 158.

¹⁶⁸ 26 U.S.C. § 856(d)(2)(B), (d)(5) (2006 & Supp. II 2008). *See*, e.g., Rev. Rul. 70-542, 1970-2 C.B. 148.

¹⁶⁹ 26 U.S.C. § 856(d)(2)(B)(i) (2006 & Supp. II 2008).

¹⁷⁰ *Id.* § 856(d)(2)(B)(ii) (2006 & Supp. II 2008).

¹⁷¹ *Id.* §§ 318 (2006), 856(d)(5) (2006 & Supp. II 2008).

¹⁷² See generally id. §§ 267(c)(5), 318(a)(5)(A), 707(b)(3) (2006).

¹⁷³ *Id.* §§ 318(a)(2)(C), (a)(3)(C) (2006), 856(d)(5)(A) (2006 & Supp. II 2008).

¹⁷⁴ Id. §§ 318(a)(3)(A) (2006), 856(d)(5)(B) (2006 & Supp. II 2008).

¹⁷⁵ *Id.* § 856(d)(2)(B), (d)(8) (2006 & Supp. II 2008).

¹⁷⁶ *Id.* § 856(d)(7)(A)(ii) (2006 & Supp. II 2008).

¹⁷⁷ *Id.* § 856(c)(2)-(3), (d)(7)(A), (d)(7)(C) (2006 & Supp. II 2008); Treas. Reg. § 1.856-4(b)(5)(ii) (as amended in 1981). Examples include: establishing rental rates and terms,

REIT INVESTMENT

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71

devastating to an entity's qualification to make a REIT election, because all income originating from a particular real property becomes non-qualifying income, once the amount attributable (together with all other impermissible tenant services income at the property) exceeds a 1% de minimis limit. 178 A REIT may therefore delegate impermissible management or operational activity to qualifying independent contractors. 179 Alternatively, a REIT can usually isolate management or operational activities within its taxable REIT subsidiaries. 180

Difficulties in Splitting a Destination Gaming Resort Under Conventional REIT Structuring Arrangements

In theory, a non-gaming business that combines readily separable active and passive real property can be split, dividing the passive and active components of its real property and positioning it to monetize its investment in passive real property. Once severed, the passive real property can be transferred to a REIT, allowing the REIT, through direct operation, to access the active and passive business available at the passive real property (with active business realized in after-tax form). Alternatively, a REIT can acquire the property and use an operator lease with an unrelated operator (or the seller), deriving only passive business. As detailed above, direct operation for most passive real property is feasible unless the value of all the active business placed in taxable REIT subsidiary solution will be larger than 25% of its assets, or its distributions will cause the REIT to fail the 75% Income Test. If the active business exceeds these limits, direct operation is unavailable. 181 Accordingly, only in limited cases is the remaining active business so large that the REIT qualifica-

selecting tenants, entering into leases, renewing leases, and dealing with REIT tax, insurance, and interest (when they arose in connection with the REIT's real property).

¹⁷⁸ 26 U.S.C. § 856(d)(7)(B) (2006 & Supp. II 2008). A REIT may also directly operate or manage its properties, as customary, but only to the extent that specific tax-exempt entities could without triggering unrelated business income tax. Id. § 856(d)(7)(A), (d)(7)(C)(ii) (2006 & Supp. II 2008). See supra note 95.

¹⁷⁹ 26 U.S.C. § 856(d)(7)(C)(i) (2006 & Supp. II 2008).

¹⁸⁰ Id. However, the rules preclude a REIT from using a taxable REIT subsidiary from managing or operating a lodging facility, whether or not gaming exists at the property. Id. § 856(d)(9)(A), (d)(9)(D) (2006 & Supp. II 2008).

¹⁸¹ A REIT's isolating active business within a wholly owned corporate subsidiary capable of delivering personal services (such as a taxable REIT subsidiary) is not feasible when the stock owned could present such relative value and voting power that it violates the securities tests of 26 U.S.C. § 856(c)(4)(B)(ii) (2006 & Supp. II 2008) and/or its corporate distributions cause the REIT to fail the 75% Income Test. Technically, the amount forgone is equal to those components of the active business that cause the taxable REIT subsidiary to exceed the 25% limitation, after reduction for any unused part of the REIT's directly realizable 1% de minimis non-qualifying income, at the property as calculated under 26 U.S.C. § 856(d)(7)(D) (2006 & Supp. II 2008) (subject to the overarching limit of the 5% of REIT gross income that is unrestricted by the 95% Income Test) or which would cause the taxable REIT subsidiary's distributions to produce more than 25% of REIT gross income from nonqualifying sources under the 75% Income Test. Faced with this problem, a REIT may use sufficiently unrelated lessees or independent contractors or independent third party suppliers to separately arrange services constituting the excess active business. It may also divest itself of active business whose value exceeds the amount that can be isolated in a subsidiary, or lease the entire property to a sufficiently unrelated operator.

UNLV GAMING LAW JOURNAL

[Vol. 2:47

tion rules frustrate direct operation. However, if the active and passive real property based businesses are dependent and intertwined, any severing necessary to direct operation is inadvisable if one or both aspects of the business risk being significantly compromised and the risk cannot otherwise be addressed.

1. Economic Penalties Attaching to Direct Operation of Destination Gaming Resorts

The restrictions on REITs prove substantially more limiting if the severed passive real property is part of a destination gaming resort. Here, even if the active business aspects of the severed passive real property were not substantial and valuable enough to thwart direct operation, 182 the lodging and gaming aspects effectively preclude it. Unable to use a taxable REIT subsidiary, a REIT engaging in direct operation cannot realize the active business available. 183 Here, it would be forced to forgo realizing upon all but a de minimis amount of the active business income available, limiting its income at the property to passive business (including customary services that would not yield impermissible tenant services income).¹⁸⁴ In effect, this forces the REIT to choose between allowing an independent third-party supplier and/or a substantially unrelated independent contractor to realize the active business available¹⁸⁵ or abandoning direct operation for an operator lease (with a substantially unrelated lessee 186 who derives all the active and passive business available). 187 For these reasons, a split-up transaction involving gaming hospitality

¹⁸² See infra note 203.

¹⁸³ That is, excepting only active business that will be 1% or less of the property's gross income, and fall within the overall 5% of REIT gross income that is unconstrained, so as not to cause the REIT to fail the 95% Income Test or develop non-de minimis impermissible tenant services income. See supra note 123.

¹⁸⁴ Here, the REIT would derive income from the supply of rooms for mere occupancy, de minimis chattel rentals and general customary services, falling within the exception to impermissible tenant services income set out in 26 U.S.C. § 856(d)(7)(C)(ii) (2006 & Supp. II 2008). The balance of the fees for hotel guests comprises the active business available at the resort's passive real property, such as fees for personal services and non-de minimis chattel rentals. Operation of the facility (including guest registration and billing) would be performed by independent contractors, using a hotel brand name, with qualifying income remitted to the REIT after collection, and deduction of management fees. See supra notes 94, 99, 122, 157, and 168. But cf. Treas Reg. § 1.761-2(a) (1972).

Treas. Reg. § 1.856-4(b)(5)(i) (as amended in 1981). The independent contractor cannot own more than a 35% interest in the REIT (directly or by attribution), and the REIT shareholders cannot own a more than 35% interest in the independent contractor (directly or by attribution). 26 U.S.C. § 856(d)(3) (2006 & Supp. II 2008).

¹⁸⁶ For this arrangement to permit the REIT to derive qualifying rents, it is important that the REIT does not own the lessee (directly or by attribution) in an amount equal to or greater than 10%. Similarly, where the master lessee is a REIT shareholder, its leasing activity can render the REIT's income from the property non-qualifying under the restrictions on rental arrangements with related parties. See supra note 170 and accompanying text. See also supra note 183. The lease cannot be perpetual, as this is equivalent to a sale. I.R.S. Priv. Ltr. Rul. 90-26-033 (June 29, 1990). In this way, the REIT only leases or licenses real property, while a sufficiently unrelated master lessee supplies personal and general services, in the same general structure reviewed in Rev. Rul. 80-297, 1980-2 C.B. 196. See supra note 158 and accompanying text.

¹⁸⁷ Or by resorting to sufficiently unrelated lessees. *See supra* note 183 and accompanying text. The lease could be based on a gross profit percentage. See supra note 96.

Spring 2011] REIT INVESTMENT

property¹⁸⁸ carries inherent economic disadvantages if a REIT is the acquirer. 189

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If a REIT opts for an operator lease, it confronts a business problem. The gaming and active services components depend, in substantial part, on a guest's hospitality experience and the property's upscale design and reputation. Similarly, the passive real property (hospitality) business depends, in substantial part, on the luxury gaming and personal services experience of guests. Because the passive real property transferred is essential to the success of the destination gaming resort's active real property in these ways, it is unlikely that it would fully monetize and completely exit its underlying real property investment through a transaction with a REIT. It is likely it would only exit its passive real property if it had sufficient certainty that its operator would not conflict with, or undermine, its active business. Because the only reliable assurance available is to remain in possession under a master lease, the transaction would be an operator lease under which the destination gaming resort continued to control the passive real property transferred as lessee; that is, a sale leaseback.

2. Potential Inadequacy of Sale Leaseback Solutions

Sale-leaseback buyers are generally in the business of acquiring properties from their occupier-owners, then leasing them back to the seller under a triple net lease. 190 As seller, the destination gaming resort generates capital from the sale and typically frees its balance sheet of debt encumbering the sold real property, thereby effectively monetizing any tied-up capital. This arrangement does not, directly, produce any increase in tax efficiency (although it might permit a destination gaming resort to avoid public listing). As rent accrues under the operator lease, the destination gaming resort is obliged to pay but remains in possession, and therefore in control, of the entire real property. Even so, a destination gaming resort likely needs a long-term arrangement not to impair its underlying active and passive businesses. 191 Additionally, a REIT may be reluctant, as it will gauge the potential effect on its income of a default under the lease where it re-enters possession. A substantial detriment to a saleleaseback is the fact that the sale transaction is one in which any taxable gain will be immediately recognized by the selling destination gaming resort. 192

3. Inadequacy of Transfer for REIT Equity Solutions

Instead of a sale-leaseback for cash, a destination gaming resort may consider transferring its passive real property for REIT equity, configuring it to

73

¹⁸⁸ Or where the active business available at the severed passive real property is so significant that it exceeds 1% of all property income (the amount that could be realized directly by the REIT). See supra note 185.

¹⁸⁹ This would be expressed as a lower value for the passive real property from the perspective of the REIT but the disadvantage may be sufficiently countered by the REIT's tax efficiency. If a master lease arrangement was used, the fair market value rent would reflect the income available to the lessee from both active and passive business. Here, the REIT indirectly accesses a portion of the active and passive business available.

¹⁹⁰ That is, a lease providing payments to the landlord net of insurance, maintenance, real property taxes and utilities.

See supra text accompanying note 188.

¹⁹² 26 U.S.C. §§ 11(a), 61(a)(3), 311(b), 1001(c) (2006).

[Vol. 2:47

access REIT tax efficiency as to the passive business realizable (and ultimately, when it exits, to monetize its investment in passive real property). 193 Here, it is important to recall that its restructuring with a REIT has the dual and competing aims of monetizing its investment in its capital-intensive passive real property, and, pending monetization, to improve its tax efficiency—insofar as its passive real property based income—or all its business income when the transaction permits the active gaming business to avoid Subchapter "C" taxation. A transfer for equity configures it to achieve both purposes, albeit successively. 194 However, even if the transfer of real property is to a REIT that the destination gaming resort effectively controls, ¹⁹⁵ if the real property has significant appreciation (hereinafter "built in gain"), the tax triggered is often prohibitive. Significantly, where the consideration received is a substantial equity interest in the purchaser in relatively liquid form, like publicly traded REIT stock, the business retains an indirect and potentially controlling interest in the passive real property's future economic returns but the exchange is commonly taxable. 196 It is unlikely, however, given these dependent and intertwined active and passive business components that it would seek to fully monetize and completely exit its passive real property investment through a transaction with a REIT (even if it received substantial or controlling REIT equity or continued in possession as lessee under an operator lease). First, the potential for conflicts of interest between it and the REIT remain, with potential fiduciary duties fettering any actual exercise of control. Second, if the destination gaming resort obtains more than a nominal equity interest in the REIT, its lease arrangement would be subject to the restrictions on rental arrangements with related parties.¹⁹⁷ This would tend to preclude the destination gaming resort from acting as master lessee, leading to the introduction of an unrelated third-

 193 However, an improvement in tax efficiency may require additional steps. See infra Part IV.E.

¹⁹⁴ See infra Part IV.E.

¹⁹⁵ A transfer is to a controlled REIT when the transferor has, or will thereby acquire, control for purposes of 26 U.S.C. §§ 351(a), 368(c) (2006). Normally, a contribution of real property to a publicly traded REIT in exchange for stock fails the non-recognition requirements of 26 U.S.C. § 351(a) (2006), due to the contributor's lack of 80% control over the REIT. Cf., Id. § 368(c) (2006). Nevertheless, the contribution is also a taxable event if it is to a REIT that is an investment company, a result that depends on diversifying the contributor interests. Id. § 351(e) (2006); Treas. Reg. § 1.351-1(c) (as amended in 1996). See also Rev. Rul. 87-9, 1987-1 C.B. 133. An analogous provision to 26 U.S.C. § 351(e) (2006) exists for partnership contributions to an investment partnership, but these transactions generally will not activate them, as the partnerships do not hold stock, securities or REIT interests. 26 U.S.C. § 721(b) (2006); Treas. Reg. § 1.721-1(c)(1) (as amended in 1996). Other Subchapter "K" specific rules may force the contributors to recognize their built in gain. 26 U.S.C. §§ 704(c)(A)(i), 737 (2006). Under 26 U.S.C. § 357(c)(1) (2006), a contribution transaction can be tax detrimental if debt encumbering the assets exceeds their adjusted basis, but partnership based transactions allow for management of an analogous issue under 26 U.S.C. § 752 (2006) (which normally permits partners control the amount of debt they are deemed to shed, and thereby control over whether the contribution results in a taxable event). 196 Depending on the form of the transfer, it may or may not be taxable. Cf. Id. §§ 1001, 351(a), (e), 357(a)-(b)(1)(B) (2006). See infra note 197.

¹⁹⁷ See supra text accompanying note 170. In some cases, complimentary accommodations supplied to gaming patrons by the destination gaming resort might be limited by the restrictions on rental arrangements with related parties.

REIT INVESTMENT

75

8:40

party lessee, which could impair the destination gaming resort's underlying active business.

Whatever the amount of equity received, the transfer remains generally taxable. If the equity received is less than 10%, the destination gaming resort could act as lessee under an operator lease, deriving the active and passive business, because the restrictions on rental arrangements with related parties would not apply. However, there is a weak business case for such an arrangement, because the lack of control over the REIT represents a potential risk (even if in possession) and the result of the transaction is merely to interpose a REIT between the destination gaming resort and the passive business in a taxable transaction without receiving cash proceeds.

C. Promise of Direct Operation Through Partnership Joint Ventures

Helpfully, administrative guidance, ¹⁹⁸ suggests a tiered partnership ¹⁹⁹ arrangement could serve to filter the active and passive assets and income of a destination gaming resort, with the passive real property transferred for the near economic equivalent of substantial REIT equity, as a prelude to final monetization in a tax efficient transaction, without necessarily impairing the REIT under the qualification rules or requiring the relinquishment of all, or a portion, of the active income available at the passive real property to unrelated parties. Moreover, this arrangement ultimately allows the REIT to engage in direct operation of the passive real property and the shareholders of the destination gaming resort to access REIT tax efficiency as to the severed passive business, without foregoing all or a portion of the active income available. Surprisingly, this result appears to hold, notwithstanding that it involves related parties for purposes of the REIT qualification rules and the real property is a lodging property with gaming. This outcome results from isolating the active business components away from the REIT's corporate structure, limiting the REIT to owning passive real property and to direct operation of a purely passive business,²⁰⁰ with active business realized at the severed passive real property by related parties under a property rights based division²⁰¹ and the operation and management of the passive real property delivered by an independent contractor (who,

198 The term refers to pronouncements like Revenue Rulings (items prepared for a specific taxpayer that the Internal Revenue Service has determined warrant publication) and Private

taxpayer that the Internal Revenue Service has determined warrant publication) and Private Letter Rulings (items prepared by the Internal Revenue Service in response to taxpayer's request which are available but not published). However, neither source carries precedential weight and cannot bind the Internal Revenue Service, as stated in 26 U.S.C. § 6110(k)(3) (2006 & Supp. I 2007).

¹⁹⁹ A tiered partnership is an ownership arrangement where one partnership (termed the "parent") owns a partnership interest in another partnership (termed the "lower-tier partnership"), which may be repeated through multiple tiers of partnerships.

²⁰⁰ As well as customary services that would not give rise to unrelated business taxable income. 26 U.S.C. \$856(c)(2)-(3), (d)(1)(A)-(B), (d)(2)(C), (d)(7)(C)(ii) (2006 & Supp. II 2008); Treas. Reg. \$1.856-4(a)-(b) (as amended in1981). See supra note 168.

Without producing impermissible services income, or deriving non-real estate assets based on active business for purposes of 26 U.S.C. \S 856(c)(4)(A), (d)(2)(C), (d)(7)(A) (2006 & Supp. II 2008).

as licensee of the destination gaming resort, uses its hospitality brand name), ²⁰² using the special tax rules for determining a REIT's ownership of assets and income that is isolated in partnership solution, and isolated within a tiered partnership arrangement.

Partnerships are very important to REITs. To further their ability to acquire qualifying assets and income, REITs have developed transactions allowing them to acquire built-in gain real property, while nonetheless permitting asset owners to receive the near economic equivalent of REIT equity, yet defer recognition of their built-in gain. REITs achieve this feat by using relatively liquid partnership interests as consideration.²⁰³ These transactions are commonly called umbrella partnership REITs (hereinafter "UpREIT transaction") or down REIT partnerships (hereinafter "DownREIT transaction").²⁰⁴ UpREIT and DownREIT transactions are common because they permit real property owners to substantially monetize their real property investment without any immediate recognition of built-in gain—that is, on a tax-advantaged basis—improving their liquidity, diversifying their investment, preserving any single level tax on the gain, permitting a step-up in basis at death,²⁰⁵ and an

 202 Whose equity owners hold no more than 35% of the REIT's equity, directly and by attribution of shares. *Id.* § 856(d)(3), (d)(5) (2006 & Supp. II 2008).

²⁰³ Treas. Reg. § 1.856-3(g) (as amended in 1992). See also I.R.S. Priv. Ltr. Rul. 95-08-019 (Feb. 24, 1995); I.R.S. Priv. Ltr. Rul. 95-07-007 (Feb. 17, 1995). The use of partnership interests avoids REIT qualification problems from excessive subsidiary corporation securities value. Partnership based arrangements could interfere with a REIT's capacity to meet the 26 U.S.C. § 856(c)-(d) (2006 & Supp. II 2008) tests if they were regarded as intangible property. However, under Treas. Reg. § 1.856-3(g), a REIT is not deemed to own intangibles but instead to "own its proportionate share of each of the assets of the subsidiary partnership, and will be deemed entitled to the income of the partnership attributable to the income of the partnership attributable to such share . . . [f]or purposes of section 856, the interest of a partner in the partnership's assets shall be determined in accordance with his capital interest in the partnership . . ." (emphasis added). Helpfully, the REIT qualification rules' limitations on the amount of securities owned pursuant to 26 U.S.C. § 856(c)(4)(B) (2006 & Supp. II 2008) generally do not treat partnership interests as securities. Id. § 856(m)(3)(A)(i), (m)(4) (2006 & Supp. II 2008); Treas. Reg. § 1.856-3(e). Otherwise, a look-through approach applies allowing securities held in partnership solution to be deemed carried by the REIT. 26 U.S.C. § 856(m)(3)(A)(ii) (2006 & Supp. II 2008). See supra note 58. Finally, the 5-50 Rule's restrictions on closely held REIT ownership do not apply to partnerships. 26 U.S.C. §§ 542(a)(2) (2006), 856(a)(6), (h)(1)(B) (2006 & Supp. II 2008); Treas. Reg. § 1.856-1(b)(6)-(7), (d)(5) (as amended in 1981).

²⁰⁴ UpREIT transactions differ from DownREIT transactions in several important respects. In a typical UpREIT transaction, the REIT configures one subsidiary partnership into which it contributes all of its real property assets. In a DownREIT transaction, the subsidiary partnership is formed specifically to hold the built-in gain property of the particular real property contributors; the REIT's other real properties are not contributed. Consequently, in an UpREIT transaction, the REIT conducts its entire real property business indirectly through its UpREIT subsidiary partnership, and built-in gain real property contributors end up with an interest in all the REIT's real property. In a DownREIT transaction, the built-in gain real property contributors end up with an interest in the DownREIT subsidiary partnership that holds assets distinct from the REIT's portfolio of real property assets and all pre-transaction REIT real properties remain at REIT level. *See generally* Su Han Chan, John Erickson & Ko Wang, Real Estate Investment Trusts: Structure, Performance and Investment Opportunities 48-50 (2003) [hereinafter Chan, Erikson & Wang]; Semer & Alexander, *supra* note 123, at A-28.

²⁰⁵ See generally 26 U.S.C. §§ 1014, 1022 (2006).

Spring 2011] REIT INVESTMENT

opportunity to defer recognition of the inherent gain indefinitely. For REITs, these acquisitions represent the chance to acquire the real property placed into partnership solution without using their tax-paid capital and without presently transferring any REIT stock to the real property owners (avoiding any immediate additional stock or debt issuance, or acquisition funding issues, and allowing REITs to fund their future real property acquisitions through partnership interests, as if equivalent to cash).²⁰⁶ Finally, a REIT can use the UpREIT or DownREIT structure to avoid the 5-50 Rule's limitation on closely held REITs, because these limits to do not apply to operating partnerships.²⁰⁷ However, use of an UpREIT or DownREIT partnership structure is not cost-free, because partnership accounting and tax rules are complex and costly.²⁰⁸ Also, a publicly traded REIT's capital raising activities can be impaired by these structures, because title to the real property normally remains in the subsidiary operating partnerships, in order to defer contributors' taxable gain.²⁰⁹

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A REIT's interest in the assets and income of any UpREIT or DownREIT operating partnership in which it is a partner (hereinafter "subsidiary partnership"), for the purpose of applying the REIT qualification rules set out in IRC § 856(c) and (d), is determined under Treas. Reg. § 1.856-3(g).²¹⁰ This longstanding regulation provides that the REIT is treated as if it directly owned its proportionate share of all the assets in subsidiary partnership solution and as if it was entitled to the income of the subsidiary partnership attributable to its proportionate share of all its assets. Under recent guidance, a REIT's proportionate share in a subsidiary partnership's assets and income, for purposes of the REIT qualification rules, is the REIT's capital interest in the subsidiary partnership, which is determined by dividing the REIT's IRC § 704(b) computed capital account by the sum of all the capital accounts in the subsidiary

²⁰⁶ Chan, Erickson & Wang, *supra* note 204, at 50.

²⁰⁸ Chan, Erickson & Wang, supra note 204, at 50.

²¹⁰ Id. § 856(c)-(d) (2006 & Supp. II 2008). See supra note 120. Treas. Reg. § 1.856-3(g) (as amended in 1992). See also I.R.S. Priv. Ltr. Rul. 2002-34-054 (Aug. 23, 2002); Rev. Rul. 69-40, 1969-1 C.B. 188. Compare Treas. Reg. § 1.856-3(g) (REIT deemed to realize proportionate share of partnership income and assets) with 26 U.S.C.A. § 512(c) (West, Westlaw through Pub. L. No. 111-312 effective Dec. 17, 2010). Tax Reform Act of 1976, H.R. 10612, 94th Cong., Pub. L. No. 94-455, 90 Stat. 1520, 1742 (1976) (tax exempt partner required to include its distributive share of partnership income in computing unrelated business taxable income). Superficially, this special look-through rule for REIT partnerships (constraining the effect of partnership investments by REITs to its proportionate share for all purposes of 26 U.S.C. § 856 (2006 & Supp. II 2008)) is at tension with the broad language of the impermissible tenant services income rule set out in 26 U.S.C. § 856(d)(7)(A) (2006 & Supp. II 2008) (applying to ". . . amounts[s] received or accrued directly or indirectly ...") (emphasis added). However, Treas. Reg. § 1.856-3(g) does not purport to modify 26 U.S.C. § 856(d) (2006 & Supp. II 2008); instead, it prescribes how these provisions will apply when the arrangement is a tax partnership. Given this unambiguous language and clear look-through approach prescribed by Treas. Reg. § 1.856-3(g) (1962), these provisions do not conflict. Accordingly, under certain circumstances, it appears that REIT partnerships permit the ordered separation (and isolation) of REIT undesirable assets and income in a manner unavailable to non-partnership entities or arrangements.

See supra note 48.

²⁶ U.S.C. §§ 704(c), 737 (2006).

UNLV GAMING LAW JOURNAL

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[Vol. 2:47

partnership.²¹¹ Accordingly, a REIT is deemed entitled to realize the tax items of a subsidiary partnership attributable to its proportionate share of all the subsidiary partnership's assets, as shown by its relative capital account balance.²¹² However, the REIT's actual distributive share of subsidiary partnership tax items, for tax purposes other than testing assets and income under the REIT qualification rules, does not need to be proportional to its interest in partnership capital.²¹³ Consequently, allocations in accordance with partnership interests, or not in accordance with partnership interests, are permitted, notwithstanding the REIT qualification rules (subject to the inherent limits of the partnership capital accounting rules that require a recipient of partnership tax allocations to enjoy the economic benefit or detriment the allocation represents²¹⁴). Significantly, a subsidiary partnership that itself owns an interest in one or more lower-tier partnerships thereby generates assets and income for the REIT, for purposes of the REIT qualification tests.²¹⁵ Because the same capital interest rules apply to determine the upper-tier REIT's interest in the second-, third-, or lower-tier partnership's assets and income for purposes of the REIT qualification tests, a REIT is treated as if it directly owned an interest in its far-lowertier subsidiary partnership's assets and income. 216 Importantly, since this proportionate share rule establishes the effect of a REIT's investment in tiered partnerships for purposes of applying all of I.R.C. § 856, the rules appear to permit the fracturing of a business otherwise susceptible to being characterized as producing REIT undesirable lodging income into its component parts (separating payments for short term use or occupancy of real property from compensation for personal services or other active business), with REIT undesirable

income all but excluded for purposes of the REIT qualification rules.²¹⁷

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²¹¹ Treas. Reg. § 1.856-3(g); 26 U.S.C. § 704(b) (2006); I.R.S. Priv. Ltr. Rul. 2003-100-14 (Mar. 2, 2003). Although Treas. Reg. § 1.856-3(g) did not define the term "capital interest", in I.R.S. Priv. Ltr. Rul. 2003-100-14, the Internal Revenue Service concluded that the term "capital interest" referenced a partner's relative capital account balance, since the capital accounts of the partners manifest their relative net investment in the underlying partnership. Accordingly, a partner's "capital interest" constitutes their capital account balance as a portion of the sum of the aggregate of all capital account balances, from time to time. Although I.R.S. Priv. Ltr. Rul. 2003-100-14 limits its conclusions to 26 U.S.C. § 856(c) (2006 & Supp. II 2008), Treas. Reg. § 1.856-3(g) supplies a broader reach, because, by its terms, it applies to the entirety of 26 U.S.C. § 856 (2006 & Supp II 2008). Prior interpretive guidance did consider the impact of an investment in customary service delivering partnerships on REIT qualification, but these pronouncements did not define the term "capital interest" for purposes of Treas. Reg. § 1.856-3(g). I.R.S. Priv. Ltr. Rul. 94-28-018 (July 15, 1994); I.R.S. Priv. Ltr. Rul. 95-02-037 (Jan. 13, 1995). Cf., 1 WILLIAM S. McKee, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 9.03[5] (4th ed. 2009) [hereinafter McKee, Nelson & Whitmire] (citations omitted).

 $^{^{212}\,}$ I.R.S. Priv. Ltr. Rul. 2003-100-14; Treas. Reg. § 1.704-1(b)(2)(iv)(a)-(b) (as amended in 2008).

 $^{^{213}}$ McKee, Nelson & Whitmire, supra note 211, \P 9-191.

²¹⁴ Except to the extent the allocations cause it to develop too high or low a relative capital account balance. Cf, Treas. Reg. § 1.704-1(b)(2)(iii)(A).

²¹⁵ I.R.S. Priv. Ltr. Rul. 2003-100-14.

²¹⁶ *Id.*; 26 U.S.C. § 856(c) (2006 & Supp. II 2008).

²¹⁷ See Part IV.A.

REIT INVESTMENT

unknown

79

8:40

D. Structuring Direct Operation Through Partnership Joint Ventures

The REIT qualification rules' approach to subsidiary partnerships indicates that a destination gaming resort is arguably able to indirectly transfer its passive real property to a REIT for direct operation—retaining and filtering to itself the active business income and assets²¹⁸ the REIT cannot derive or own—in a way which promises to allow the parties to organize their relationship to seamlessly deliver active business at the passive real property that destination gaming resort guests demand.²¹⁹ Additionally, the arrangement would not directly limit the scale of the business conducted in partnership solution because the value limits on REIT security ownership do not generally apply.²²⁰ However, for this structure to succeed where the destination gaming resort (or its shareholders) will have, or will acquire, a substantial REIT equity interest (directly or by attribution),²²¹ the division of the destination gaming resort property must be based on retaining within the destination gaming resort a property right based entitlement²²² to derive active business at the destination

²¹⁸ That is, by keeping the active real property, while severing and transferring only the passive real property.

See supra text accompanying notes 97 and 123. However, there must be sufficient passive income in the subsidiary partnership, relative to the amount of active income filtered out of the lower-tier partnership, to permit the REIT to derive no more than *de minimis* active income from the property, after application of Treas. Reg. § 1.856-3(g). Even with the majority of the income available at the passive real property being passive and nearly all active income being diverted to the destination gaming resort, the partnership agreement will require careful crafting, but it does not appear that the REIT will inadvertently realize too much active business is necessarily a significant risk. See supra text accompanying notes 7-8. If it was, the destination gaming resort may have to move its active real property associated with the resort out of the lower-tier partnership. Because impermissible tenant services income is determined on a property-by-property basis, a REIT's transfer of unrelated passive real properties to the subsidiary partnership would be ineffective in diluting or limiting its active income at the property to below de minimis amounts. See supra note 95.

²²¹ If the equity interest is sufficient to disqualify the rental income under the restrictions on rental arrangements with related parties or the limitations on independent contractors, after application of the attribution rules, then a property rights based division is optimal. *See supra* notes 170 and 188.

²²² The partnership's entitlement to realize active business cannot arise under a lease or contract arrangement, since either arrangement can activate independent contractor problems and/or the restrictions on rental arrangements with related parties, if the equity interest received in the REIT (actually or constructively) is large enough. In contrast, if a retained property right based entitlement to realize active business at the passive real property is used (such as an easement in gross), it does not activate the leasehold based restrictions (because it is merely a non-possessory right in real property entitling its holder to the use or enjoyment of the REIT's land for specified purposes). Modern law has expanded the use of easements; though possessory, easements are not estates in land, but are interests in land. An easement: (i) is an interest in land in the possession of another; (ii) is an interest of a limited use or enjoyment of the land in which the easement exists; (iii) can be protected against the interference of third-parties; (iv) cannot be terminated at the will of the possessor of the servient land; (v) is not a normal incident of a possessory land interest; and (vi) is capable of creation by conveyance. 4 Powell on Real Property §§ 34.01-34.03 (Michael Allen Wolf ed., 2004) (citations omitted). State law normally treats easements as an interest in real property that give the holder a property right based entitlement to use the real property of another. See also Mark Lee Levine & Libbi Levine Sagev, Real Estate Transactions: Tax Planning and Consequences 61-62 (2010). It is important to note, however, that

gaming resort and/or at the passive real property. Here, the ideal arrangement appears to be an exclusive perpetual easement over the passive real property (retained by the destination gaming resort until it is optimal to transfer this item to the lower-tier partnership). In this way, the property contributed to the subsidiary partnership never includes the right to derive active business at the underlying passive real property; only the balance of the bundle of rights end up in the subsidiary partnership through which the REIT conducts direct operation of the purely passive and customary services aspects of the passive real property.²²³ Consequently, the destination gaming resort's contribution of real property to the subsidiary partnership is less than its complete bundle of rights, retaining within itself, in the form of a property right, the right to derive active business.²²⁴

So arranged, the right of the destination gaming resort (or any other partnership it contributes this property to) to derive income from active business at the property depends on its retained property rights, not a contract or leasehold based relationship with the subsidiary partnership or REIT. Using a property right based arrangement is important because conventional structures²²⁵ for

while the tax consequences of a business arrangement are influenced by its attributes under local law, local law is not controlling. However, a retained easement as to active business in a tiered partnership that filters active business away from the REIT is analogous to the coownership arrangement described in Rev. Rul. 74-353, 1974-2 C.B. 200 (holding the rents untainted by a co-owner's realizing income from submetering electricity, provided the REIT derived no direct or indirect income or benefit therefrom).

²²³ Rev. Rul. 67-218, 1967-2 C.B. 213 (an easement has been viewed as a non-possessory real property interest for tax purposes). Given the broad definition of real estate assets for purposes of the Assets Test, the bundle of rights (after reduction for an easement) should constitute a real estate asset in the hands of the subsidiary partnership through which the REIT derives qualifying income. Cf. Treas. Reg. § 1.856-3(d). Notably, the REIT could manage the passive real property business in subsidiary partnership solution, directly, to the extent its management represents discharging a fiduciary duty, and through a sufficiently unrelated independent contractor. Provided the attribution rules did not activate the restrictions on substantially related independent contractors, the destination gaming resort (or its principals or founders) could supply management and operation as an independent contractor. See supra note 145.

²²⁴ The transfer of an easement to the lower-tier partnership aims to constitute a non-recognition transfer of property to a partnership in exchange for a partnership interest, much like the transfer of the passive real property to the subsidiary partnership, under 26 U.S.C. § 721 (2006).

²²⁵ Common structures for dividing or limiting access to, or the business realizable on, real property, are co-ownerships, partnerships/joint-ventures, contracts or leaseholds. However, a co-ownership may be a partnership for tax purposes. Treas. Reg. § 301.7701-3(a) (as amended in 2006); Treas. Reg. § 1.761-1(a) (as amended in 1995). Cf. Treas. Reg. § 1.761-2 (as amended in 1995). Even if not, under the doctrine of unity of possession, each coowner is deemed to own an undivided interest in all of the property, with the associated right to possess the whole, and to a proportionate share of all of the rents or profits derived. 7 POWELL ON REAL PROPERTY § 50.01-50.07 (Michael Allen Wolf ed. 2000) (citations omitted). See, e.g., Rev. Proc. 2002-22, 2002-14 I.R.B. 733. But see Rev. Rul. 74-353, 1974-2 C.B. 200 (REIT and unrelated corporation were co-owners of real property, no claim of tax partnership, qualifying rent was untainted by co-owner's submetered electricity sales to tenants when arranged to supply no direct or indirect income or benefit to the REIT). A coownership involving leasing property and supplying services could introduce active income and assets into the REIT. 26 U.S.C. § 761(a) (2006 & Supp. I 2007); Treas. Reg. § 1.761-1(a) (1960); Treas. Reg. § 301.7701-1(a)(2) (1967). Similarly, a partnership would deem

REIT INVESTMENT

unknown

81

8:40

dividing income realized from a property are frustrated by the REIT qualification rules if even modest REIT equity is the consideration. Helpfully, this arrangement also has the salutary effect of reducing the risk of inadvertently introducing into the REIT intolerable active business and assets, which reduces the imperative that management and control over the subsidiary partnership be vested exclusively in the REIT. Simultaneously, severing active business from the passive real property conveyed through an easement limits the subsidiary partnership to merely passive business—which partially obviates the need for the destination gaming resort acquiring a controlling interest in the REIT or subsidiary partnership—in order to protect its dependent and intertwined active business, and lessens any objection it has to the REIT acquiring a controlling interest in the subsidiary partnership.²²⁶ Finally, severing the active business remaining at the passive real property permits the destination gaming resort to continue or restructure itself to realize its business in tax-efficient form because the active business is no longer married to capital-intensive passive real property, and the need to access capital through a public listing transaction has been substantially reduced or eliminated.

However, some destination gaming resorts will find such a property rights based division unworkable or unsatisfactory, as it divides assets in a manner that is unusual for publicly traded enterprises, introducing uncertainty and risk that may result in market penalties. Additionally, whether the passive real property can generate enough passive business to be distributed to the REIT justify the amount of REIT investment required to fully monetize the destination gaming resort's investment is unclear; it may be the case that the passive business available cannot support the REIT investment needed to fully monetize it. However, a more realistic view is that the destination gaming resort will, on its exit, fully monetize its capital investment in passive real property because, all things being equal, any difference between the amount of capital invested in passive real property and the value of the subsidiary partnership interest received is attributable to the active business it retained.²²⁷

each partner to own active assets and realize active income of the partnership in accordance with their proportionate interest in the partnership, introducing undesirable active assets and income into the REIT. Treas. Reg. § 1.856-3(g). Moreover, a contract or lease based arrangement cannot be ones where the independent contractor limits and restrictions on rental arrangements with related parties activate, which effectively limits the destination gaming resort to a low equity interest in one of the REIT or active business entities. *See supra* note 188. *Cf.*, Treas. Reg. § 1.761-2(a)(3). A tiered partnership structure used to filter active business away from the REIT does not raise the past policy problems of partnership based arrangements that deliver disqualified income to the REIT concealed primarily as interest. S. Rep. No. 106-201, at 57 (1999) (describing partnership arrangements involving REITs permitting them to realize non-qualified income disguised as qualifying interest).

²²⁶ Severing the personal services intensive active real property from the occupancy based passive real property may help the income qualify as rents. *See supra* Part IV.A.

Whether the destination gaming resort can fully recover its investment made in passive real property depends on the value of the passive real property, after carving out any retained property rights (such as an exclusive easement as to active business at the passive real property). The value of the passive real property determines the amount the REIT must contribute and the percentage interest the destination gaming resort will receive in the subsidiary partnership. *See supra* note 18.

UNLV GAMING LAW JOURNAL

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[Vol. 2:47

This relationship might arise as follows. First, the REIT and the destination gaming resort contribute other property or cash and the passive real property, respectively, to a subsidiary partnership.²²⁸ Essentially, the transaction is an UpREIT or DownREIT transaction.²²⁹ Here, the destination gaming resort contributes the passive real property components that a REIT is permitted to own and operate, 230 but the contribution would not include legal title to those portions of the property that yield purely or predominantly active business, such as the gaming floor (in addition to the carve out of an easement relating to active business at the passive real property). If the REIT contributed (or had previously contributed) cash or equity in other property sufficient to exceed the net value of the contributed passive real property, the REIT would generally acquire the largest capital account in the subsidiary partnership (the passive real estate assets, and tax items attributable thereto, would therefore be deemed owned and realized predominantly by the REIT, for purposes of the REIT qualification rules).²³¹ The destination gaming resort would separately contribute its active business assets to a lower-tier active partnership it forms with the subsidiary partnership, so that it derives almost all of the capital account inter-

22

82

To ensure that the arrangement qualifies as a partnership for tax purposes, it is important (among other criteria) that the partnerships each manifestly conduct business for profit or gain (with their respective partners carrying on joint activities for profit), and divide the profits as contemplated in 26 U.S.C. § 761(a) (2006 & Supp. I 2007). Treas. Reg. § 301.7701-1(a)(2) (as amended in 2009). *Cf.*, 26 U.S.C. § 704(e) (2006). Additionally, the two-tiered partnerships should not risk being deemed partners of a notional separate lowest tier partnership, which requires careful planning, including each partnership conducting its active business or passive business independently of the other and without sharing profits or losses (or control over the other's income and capital). Luna v. Comm'r, 42 T.C. 1067 (1964); W.G. Alhouse v. Comm'r, 62 T.C.M. (CCH) 1678 (1991); D.J. Lausterer v. Comm'r, 69 T.C.M. (CCH) 2247 (1995); I.R.S. Priv. Ltr. Rul. 1999-17-039 (Apr. 30, 1999); I.R.S. Priv. Ltr. Rul. 2000-28-014 (July 14, 2000). Finally, the transaction must not activate the partnership anti-abuse rule. Treas. Reg. § 1.701-2 (as amended in 1995); Semer & Alexander, *supra* note 123, at A-31.

²²⁹ If a DownREIT transaction is used, the transaction requires careful planning in order to maintain economic equivalence between the subsidiary partnership interests held by the destination gaming resort and the distributions made on REIT equity. Semer & Alexander, *supra* note 123, at A-30.

 $^{^{230}}$ Using an independent contractor. Chan, Erickson & Wang, supra note 204, at 50.

Because of the way the REIT partner's interest in partnership solution assets and income is determined for purposes of the REIT qualification rules under Treas. Reg. § 1.856-3(g), there is a tax imperative to keep the REIT's capital account and partnership interest substantially the largest in the subsidiary partnership, if it wants to derive the greatest amount of qualifying assets and income. Cf., Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 2008). Moreover, to avoid the 26 U.S.C. § 857(b)(6)(A) (2006 & Supp. II 2008) prohibited transaction tax (applying at the confiscatory rate of 100%), any allocations from the lower-tier partnership that constitute inventory type gains should be made to the destination gaming resort. While the REIT's capacity to invest in this transaction is dependent on finely calibrating the amount of qualifying income and non-qualifying assets and income it derives out of the tiered partnership arrangement, it is also important that the arrangement supply the destination gaming resort and the REIT with the designated economic return on its contributed assets (for the destination gaming resort, before it fully monetizes its investment). Achieving the desired economic return and tax consequences requires a sophisticated partnership agreement, a discussion that is beyond the scope of this article. Cf., SEMER & ALEX-ANDER supra note 123, at A-30.

est in this lower-tier partnership.²³² The assets contributed would include the exclusive property right—such as an exclusive perpetual easement—to conduct active businesses at the property, the retained purely active business and at least some active real property.²³³ Accordingly, the active business assets of the lower tier partnership, and tax items attributable thereto, would be derived almost entirely by the destination gaming resort, not the subsidiary partnership, and therefore not the REIT, for purposes of the REIT qualification rules.²³⁴

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Through this sequence of transactions, the destination gaming resort would receive partnership interests in the subsidiary partnership and lower-tier partnership, although the REIT would receive partnership interests in the subsidiary partnership alone. Importantly, although the distinct active and passive real property would be held by affiliated but separate partnerships and not under lease(s), the delivery of services at the destination resort would be relatively seamless (since personal services are concentrated in the lower tier partnership) and not predicated on a contract or a leasehold arrangement. Through these partnership contributions, the REIT has acquired passive real estate assets and qualifying passive income, for purposes of the REIT qualification rules, ²³⁵ the destination gaming resort has positioned itself to substantially monetize its investment in its passive real property, able to free up sunk capital when needed and focus on its underlying active businesses. The parties deliver a consistent guest experience and are not compelled to forgo realizing active business otherwise available. Instead, active business is realized by the destination gaming resort, through its interest in the lower-tier active partnership, where it or its shareholders' equity position in the REIT would preclude its qualifying as an independent contractor or would activate the restriction on rental arrangements with related parties. However, even though the REIT is limited by this direct operation arrangement to realizing strictly passive income at the passive real property, the subsidiary partnership would rely on an independent contractor to manage and operate the passive real property. 236

E. When Additional Restructuring is Required for Improved Tax Efficiency

Normally, transferring its passive real property aspects to a REIT will not itself improve the tax efficiency of an existing publicly traded destination gam-

²³² I.R.S. Priv. Ltr. Rul. 2002-34-054 (Aug. 23, 2002); I.R.S. Priv. Ltr. Rul. 2003-100-14 (Mar. 7, 2003). Here, the REIT, through the subsidiary partnership, would contribute cash or

property of relatively little value to the active lower-tier partnership. *See supra* note 212. ²³³ Real property assets such as the gaming floor, and the property right to derive active business at the passive real property now in subsidiary partnership solution. *See supra* note 212.

²³⁴ I.R.S. Priv. Ltr. Rul. 2003-100-14 (the items in the lower-tier partnership(s) would be deemed to be assets and income of the destination gaming resort nearly alone).

²³⁵ The subsidiary partnership would use an independent contractor for any management it engaged in beyond what it is permitted to do in discharge of its fiduciary duties. 26 U.S.C. § 856(d)(7)(C)(i) (2006 & Supp. II 2008). *See supra* Part IV.A.

²³⁶ Presumably including using the destination gaming resort brand name under license. Here, the owners of the independent contractor cannot own more than 35% of the REIT. *See supra* note 145.

ing resort.²³⁷ Until the subsidiary partnership interests received by a publicly traded destination gaming resort are distributed to its shareholders, the arrangement is not directly any more tax efficient than the pre-transaction arrangement, because the destination gaming resort will be subject to a corporate level tax on the income and gain items it is allocated from the subsidiary partnership.²³⁸ Consequently, increasing the tax efficiency of a publicly traded destination gaming resort requires a distribution of the subsidiary partnership interests received to its shareholders, because doing so eliminates the corporate level tax on all future allocations and distributions made by the subsidiary partnership.²³⁹ By making this distribution, a publicly traded destination gaming resort would recognize any gain it had in the partnership interests it distributed, 240 unless the distribution qualified for non-recognition. 241 The shareholders, in turn, would recognize the distribution as a dividend, return of capital, or capital gain, depending on the value of the property distributed, the corporation's earnings and profits, and the shareholders' adjusted basis in their shares.²⁴² After any such distribution, it is possible for the subsidiary partnership to become a disregarded entity, if the REIT acquires all of the interests therein (effectively from conversion or puts of subsidiary partnership interests).²⁴³

Optimal Candidates For Direct Operation Partnership Joint Ventures

For some destination gaming resorts, the arrangement presents an underwhelming business case, because the amount of income that would be

²³⁷ When it is a taxable corporation, such as a publicly traded destination gaming resort. See supra note 23.

²³⁸ 26 U.S.C. §§ 702(a), 11(a) (2006) (tax items allocated from the subsidiary partnership, and the lower-tier partnership, will be reported on the destination gaming resort's tax return as if it had realized those items itself. The arrangement has, however, monetized its passive real property investment). See supra note 23.

²³⁹ Those derived from the passive assets and passive income placed into partnership solution. It could also drop its public listing and restructure out of Subchapter "C".

²⁴⁰ 26 U.S.C. § 311(b) (2006). This could also trigger a partnership termination. *Id.* §§ 708(b)(1)(B) (2006), 761(e) (2006 & Supp. I 2007). See also I.R.S. Priv. Ltr. Rul. 93-32-026 (Aug. 13, 1993).

²⁴¹ Cf., 26 U.S.C. §§ 355 (2006 & Supp. I 2007), 368(a)(1)(D) (2006).

²⁴² Unless the distribution qualified for non-recognition treatment. See supra note 243. However, where the real property based business is not a "C" corporation but a tax passthrough (such as a "S" corporation or tax partnership), it is then unnecessary, from a tax perspective, to transfer the subsidiary partnership interests to the destination gaming resort's equity holders, as in all cases, only one level of taxation applies.

²⁴³ Here, the subsidiary partnership would disappear into the REIT and, for REIT qualification purposes, the lower-tier partnership would become the subsidiary partnership. Treas. Reg. § 301.7701-3(f)(2) (as amended in 2006); Rev. Rul. 99-6, 1999-1 C.B. 432. However, provided the REIT's relative capital in the lower-tier active partnership remained low, the disappearance of the subsidiary partnership as a separate entity would not introduce significant active assets or income of the lower-tier partnership into the REIT. This event would terminate the destination gaming resort's control or influence over the passive real property, if its shareholders held a less than controlling interest in the REIT; this may not prove harmful given the risk reduction owing to a property right based entitlement to derive all active income at the passive real property. In some cases, conversion may give rise to a disguised sale. Cf., 26 U.S.C. § 707(b) (2006).

REIT INVESTMENT

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85

diverted into the tax efficient REIT or subsidiary partnership is limited to the strictly passive business aspects of the resort (not all the active and passive income available) and may require the limited use of a substantially unrelated independent contractor for operation. Moreover, the direct operation arrangement may be unwelcome for existing publicly traded destination gaming resorts because it requires an unconventional and novel tiered, partnership based split up and property rights based restructuring, which may disturb firm capital and debt-raising. In this case, they may prefer a simpler sale-leaseback for cash.

For those destination gaming resort businesses that are not yet publicly listed, the arrangement may be attractive because it allows a partial exit, permitting the business to hold its valuable active business components, such as the gaming business, in a tax-efficient, non-public structure while ultimately securing a tax efficient exit from much of its capital-intensive passive real property investment.²⁴⁴ Importantly, the structure does not force the destination gaming resort to subject its valuable active business to taxation under Subchapter "C," because it allows business founders to avoid undertaking (or potentially reverse) a publicly listing transaction. Because the active real property is substantially less capital intensive, the need to directly access the capital markets is reduced. The arrangement would permit business founders to retain a substantial interest in future passive real property appreciation, through their direct or indirect interest in the REIT, if they forego monetization of all or some of their interest received while accessing REIT tax efficiency. Significantly, founders of yet to become publicly listed destination gaming resorts could support some of their estate-planning goals by converting the illiquid capital-intensive passive real property components of their destination gaming resort to liquid partnership interests or liquid REIT equity, allowing their estates to fund any federal estate taxes from liquid assets, rather than by illiquid interests in a private destination gaming resort.²⁴⁵

V. Conclusions

Destination gaming resorts demand massive amounts of capital in order to fund their investment in real property, much of which comprises areas where they realize predominantly passive business, including the hotel tower. Consequently, they generate substantial income from passive business, such as fees for hotel occupancy, even as most of their income is attributable to active business, such as gaming and personal services. Because they blend separable passive and active real property, a REIT can theoretically acquire all or some of the real property, realizing income under an operator lease with a substantially unrelated gaming or hotel lessee. Alternatively, a REIT can acquire only the passive real property aspects, limiting itself to passive income from direct operation. Unfortunately, investment in these properties is subject to gaming prop-

244

²⁴⁴ For instance, real property based business founders could hold subsidiary partnership interests convertible into liquid REIT stock, but retain substantially all of an active business conducted in the lower-tier partnership (in a tax efficient structure, such as a pass-through).
²⁴⁵ If all the partnership interests in the subsidiary partnership were quickly shifted into REIT equity or cash, the arrangement would not achieve significant tax deferral. In this case, the sale-leaseback transaction described in Part IV.B. may prove superior.

86

erty specific limits that prevent REITs from operating or leasing the hotel to its taxable subsidiaries.

The demand for capital investment in real property poses a significant business challenge to destination gaming resorts, something they often address by becoming publicly traded and through borrowing, condominium-hotel developments or sales of resort retail components. Under the theory of tax capitalization, the inherent tax efficiency of REITs position them as an ideal acquirer for a capital-intensive passive real property. Notwithstanding their annual distribution requirement, REITs are generally well capitalized, as they tend to be publicly listed. Despite this, closer examination reveals that a conventional REIT transaction would be disadvantageous. In particular, a REIT cannot engage in direct operation without forgoing profitable personal services based active business at the property (resorting to a substantially unrelated independent contractor or independent service provider, because they cannot isolate remaining active business into, or lease the property to, a taxable REIT subsidiary). Alternatively, a REIT may use an operator lease, where it forgoes all the active and passive business directly realizable (some of which is recovered in the fair market rent). Here, because the active and passive businesses at the property are dependent and intertwined, the destination gaming resort is the optimal lessee. To avoid contaminating the income, the destination gaming resort and its shareholders cannot hold substantial REIT equity.

If the REIT instead engages in direct operation, one recent ruling implied that income from short-term occupancies like hotels may be non-qualifying. Such a position would overturn the historic recognition that hotel income comprises both qualifying and non-qualifying income. Although this ruling is difficult to reconcile with other pronouncements, it is a concern. However, administrative guidance on the consequences to REITs of investing in partnerships has answered many tax uncertainties, to the extent that such guidance can. Taken together, these pronouncements suggest that a tiered partnership arrangement can be used to sever the passive real property in exchange for the equivalent of substantial REIT equity, permitting the equivalent of direct operation without introducing economic or business penalties, notwithstanding that there is gaming, provided the destination gaming resort retains a property based right to realize the active business available (such as a perpetual easement). The complexity, risk and novelty of such a transaction may be unattractive to existing publicly traded destination gaming resorts and there may not be enough income at the severed passive real property to justify the REIT investment required to ultimately monetize the resort's existing investment. However, closer scrutiny reveals that any shortfall between the total capital invested and the value of the partnership interest received is attributable to the retained active business assets. Such a division may be helpful, as it isolates REIT desirable passive business from undesirable personal services, permitting direct operation while more closely situating the arrangement within the historic treatment of passive components of hotel income as qualifying.

Significantly, for those enterprises that are private but would otherwise become publicly traded, severing the business' passive real property in this way permits them to retain a tax efficient arrangement but access REIT tax efficiency as to their passive real property (before final monetization). The trans-

REIT INVESTMENT

87

action preserves the business' ability to realize active business, while permitting it to remain privately held and organized in tax efficient structures other than Subchapter "C." Additionally, the arrangement positions the destination gaming resort to monetize all or some of its capital investment when it deems it optimal to do so, something that may be particularly welcome considering the estate planning goals of founders. For these reasons, the transaction softens the burden of capital-intensive passive real property but avoids a tax detrimental public listing transaction.

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