



new ruling on reit's in crt's

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practice areas

nonprofit organizations

transactional tax

While a charity is normally exempt from income taxes, it is subject to tax on its unrelated business taxable income (UBTI). The UBTI provisions are particularly onerous in the context of a charitable remainder trust. New rules contained in tax legislation passed in December, 2006 provide that UBTI realized by a CRT is taxed at a rate of 100%. Accordingly, a trustee of a CRT has to be very careful when contemplating any transaction which could result in UBTI.

One possible investment that a CRT might wish to make is the purchase of stock in a Real Estate Investment Trust (REIT). A REIT is a corporation that invests solely in real estate and whose stock is usually publicly traded. If the REIT meets certain tests, it is not subject to corporate income taxes, but rather taxes are paid at the shareholder level. While normally the income which a CRT receives from a REIT would not be UBTI, there was one area of concern. Specifically, if one of the assets of the REIT was a "residual interest" in an entity known as a "real estate mortgage investment conduit" there was some concern that the income generated by that residual interest would constitute UBTI, which would flow from the REIT to the CRT, and would destroy the tax exemption of the CRT.

This concern was recently put to rest by the IRS in Revenue Ruling 2006-58, holding that that, in the situation described above, CRT does not recognize UBTI and its tax exemption is not impacted. This means that the question of whether a CRT wishes to acquire or hold REIT shares is an investment issue and not a tax issue. If the Trustee of a CRT concludes that it would be wise to hold REIT shares in its investment portfolio, it can now do so without fear that its tax exemption will be jeopardized.

USE OF REITs IN CRT TAX PLANNING

The use of a REIT can help avoid problems arising from funding a CRT with encumbered real estate. These problems might involve application of the bargain sale rules, UBTI or even disqualification of the trust as a CRT. On the other hand, the equity in that encumbered real estate may be the best appreciated asset the donor can use to fund the CRT. Accordingly, it is frequently desirable to devise a structure that will enable the real estate to be



transferred to the CRT without the CRT taking over any part of the mortgage. Following are the two structures (designated as Plan A and Plan B) that will achieve this result. Plan A is simple and straight forward. Plan B involves the use of a REIT and is more complex, but can generate a better tax result.

Hypothetical Facts

Assume a taxpayer (Ms. T) owns an office building that has a \$10,000,000 fair market value, is subject to a \$4,000,000 mortgage, and thus has a \$6,000,000 equity. Further assume Ms. T's tax basis for the building is \$2,000,000. Finally assume that Ms. T wishes to transfer \$5,000,000 of asset value to a CRT.

Plan A

Under Plan A, Ms. T contributes a 50% tenancy-in-common interest in the building to a CRT, pursuant to an agreement providing that the \$4,000,000 mortgage remains Ms. T's debt, (and the CRT is held harmless from that debt). Next the CRT and Ms. T sell the building to a buyer for its \$10,000,000 assumed value, with the entire mortgage being paid out of Ms. T's 50% of the sale proceeds.

The results of Plan A are as follows:

1. The amount transferred to the CRT is 50% of the value of the building determined without regard to the mortgage – or \$5,000,000 – subject to the possibility, discussed below, that for tax purposes this amount will have to be reduced by a fractional interest discount.
2. Ms. T will recognize a \$4,000,000 capital gain on the sale of the 50% retained interest. This amount is the difference between her 50% of the sale proceeds (\$5,000,000) and her 50% of the tax basis of the building (\$1,000,000).
3. The amount of cash retained by Ms. T is \$1,000,000 (\$5,000,000 of sales proceeds minus the entire \$4,000,000 mortgage). Assume that her capital gain is taxed at a 25% rate so that the retained \$1,000,000 is sufficient to cover her tax on the \$4,000,000 capital gain (1).

Plan B

Plan B involves the use of a REIT, but not just any REIT. Rather the REIT must be one that has what is known as an "UPREIT structure". Stated simply, an UPREIT is a partnership in which the REIT is the managing partner and owns a majority interest, with other persons being minority partners. The partnership interests in the UPREIT held by the minority partners are not publicly traded, but are usually freely convertible into REIT shares which are publicly traded.

The structure of Plan B is as follows. First, Ms. T contributes the office building to the UPREIT in exchange for a \$6,000,000 partnership interest. Second, the UPREIT uses \$4,000,000 of its cash to pay off the mortgage. Third, Ms. T transfers 5/6 of her interest in the UPREIT to the CRT, retaining 1/6 of the interest for herself. Fourth, the CRT converts its interest in the UPREIT into shares of the publicly traded REIT, and then sells those REIT shares on the market for \$5,000,000. Fifth, Ms. T similarly converts her interest in the UPREIT into REIT shares and then



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sells those shares on the market for \$1,000,000. Under both Plan A and Plan B, the CRT ended up with cash of \$5,000,000 and Ms. T ended up with cash of \$1,000,000. However, the tax results to Ms. T in Plan B are superior to Plan A in three respects.

First, and foremost, Ms. T will have less capital gain under Plan B. No taxable gain will be recognized on the transfer of the building to the UPREIT; that transfer will be tax-free with a carry-over of basis. When the UPREIT pays off the mortgage, Ms. T will realize \$2,000,000 of capital gain. Under Internal Revenue Code Sections 752 and 731, paying off the mortgage is a reduction in Ms. T's liabilities, which reduces the basis for her UPREIT interest (from \$2,000,000 to zero), with the remaining \$2,000,000 of liability reduction being taxable as capital gain. In addition, Ms. T recognizes \$1,000,000 of capital gain on the conversion of her UPREIT interest into REIT shares (i.e., \$1,000,000 value less a zero basis). Her total capital gain, therefore, will be \$3,000,000. Under Plan A, Ms. T recognized \$4,000,000 of capital gain. Thus, \$1,000,000 of capital gain in effect "disappeared". Assuming a 25% tax rate, Ms. T's tax under Plan B is only \$750,000. Since she receives \$1,000,000 cash on sale of the REIT shares, under Plan B Ms. T ends up with \$250,000 of cash in her pocket.

The second advantage of Plan B is that there should be no risk of the IRS contending that a discount should be taken into account in determining the amount transferred to the CRT. In Plan A the asset transferred to the CRT is a tenancy-in-common interest in real estate, and there have been numerous cases (in the estate tax and gift tax area) which have held that a fractional interest discount is appropriate in valuing a tenancy-in-common interest in real estate. Under Plan B the asset transferred to the CRT is a partnership interest in the UPREIT, and since that partnership interest is readily convertible into publicly traded stock, no discount should be applicable.

The third benefit is that the final step in Plan B – Ms. T converting her UPREIT interest into REIT shares and selling those shares on the market – is optional. If Ms. T has cash from other sources to pay her tax on the reduction of liabilities (in the example 25% of \$2,000,000 of income or \$500,000 of tax), and believes that the REIT is a good investment, she can keep the UPREIT partnership interest in her investment portfolio. In the above example, this would mean that \$1,000,000 of capital gain is not taxed currently, but rather such gain is deferred until the time that Ms. T decides she wishes to convert her investment into cash.

Finally, coming back full circle to the way this Article started, the fourth step in Plan B, where the CRT sells REIT shares on the market, is also an optional step. By reason of Revenue Ruling 2006-58, there is no risk of the CRT inadvertently recognizing UBTI by reason of its investment in the REIT. Accordingly, the decision whether to sell or hold the REIT shares is simply an investment decision to be made by the Trustee of the CRT.

(1) This assumption is made solely for purposes of simplicity, and there are not nearly enough facts in the hypothetical example to calculate her actual tax. For example, you need to know what portion of the capital gain is "15% type" and what portion of the capital gain is "25% type". You need to know what portion of the amount transferred to the CRT will give rise to a charitable deduction. You need to know whether Ms. T has sufficient taxable income to use that deduction.

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