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What You Need to Know About Hospitality REITs

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In February 2016, Hilton Worldwide announced its plans to spin off the bulk of its hotel real estate into a publicly traded real estate investment trust (REIT) to be owned by its shareholders by the end of the year. The company's press release says the separation of the real estate from the hotel operations will allow management teams to fully activate their respective businesses, take advantage of growth opportunities and achieve tax and capital market efficiencies. The *Wall Street Journal* described the spin-off transaction as "popular among companies looking to slim down and unlock value in their real estate holdings."

In recent years, companies in various industries, including telecommunications, correctional institutions and gaming, have spun off their real estate holdings into REITs. After the spin-off, the core company leases the real estate back from the newly spun-off REIT. The core company can then concentrate its efforts on the core business, and the REIT can concentrate its efforts on the real estate business, in addition to having the tax advantages. These types of transactions are designed to be tax deferred and are extremely complicated and controversial, so much so that in December 2016, Congress passed and the President signed legislation that effectively prohibits future tax-deferred spin-offs of REITs from non-REIT companies. Hilton Worldwide is able to proceed with its spin-off because it had applied for a private letter ruling from the IRS prior to the effective date of the legislation.

So, what is a REIT and why is it suited to owning hotel properties? And what opportunities remain for hotel operators to "slim down and unlock value?"

REITs are creations of the tax law which allow smaller investors the opportunity to invest in large real estate projects that might otherwise be available only to wealthy and institutional investors. Although a REIT would normally be taxed as a corporation, the tax law requires a REIT to distribute dividends of at least 90 percent of its ordinary taxable income annually and allows it to deduct those dividends from its taxable income. REITs use this dividends-paid deduction to essentially make it a non-taxable entity. Individual REITs generally specialize in holding properties of a certain character. For example, a REIT might specialize in hotel properties, office buildings, health care properties or apartment buildings. Some REITs' stock is listed on a stock exchange. Other REITs may offer their stock in public offerings without being listed on an exchange. Still other REITs are privately-held (subject to certain ownership requirements).

Like many historic real estate deals structured as partnerships, generally only one level of federal income tax applies to the earnings of a REIT. Its shareholders are generally taxable at ordinary income rates (not the lower qualified dividends rate) on dividends received from the REIT. REITs (especially those owned more than 50 percent by U.S. shareholders) can also be an attractive investment for foreign investors seeking exposure to U.S. real estate.

In order to receive this favorable tax treatment, the tax law places a complicated web of restrictions on the nature of the income, assets and operations of a REIT. These restrictions seek to ensure that REITs are primarily investors in real estate, collecting "passive" types of income, generally rents and mortgage loan interest. A REIT will lose its tax-favored status if it has too much income from sources other than real estate assets, has too many non-real estate assets, holds ownership interests in non-REIT entities above relatively low levels or fails to distribute the required amounts of dividends to its shareholders. Because REITs must distribute their earnings annually to their shareholders, a REIT cannot finance growth through retained earnings. Instead, REITs actively raise capital in the securities markets to finance their growth.

Income derived from the operation of a hotel would not qualify as good REIT income for tax purposes. Therefore, a REIT that owns a hotel property needs another entity to operate the property. Conversely, hotel operators may want to expand without tying up available capital in real estate.

Although the spin-off technique announced by Hilton Worldwide is no longer available as a means to separate real estate from operations, hotel operators and REITs can continue to serve both their interests through the REIT's development or funding of new construction, or the sale of hotel properties to the REIT and the leasing back of those properties by the hotel operator. In addition, REIT shareholders of all sizes can choose to invest in a hotel-oriented or other category of REIT without having to be at the table when the property is developed or purchased.

The capital-raising experience of REITs, the limitations on a REIT's business operations and the capital needs of the hospitality industry combine nicely to make REITs attractive as a source of capital for the industry and an investment vehicle for investors of any size, foreign and domestic, to share in the earnings from hospitality properties.