Articles

"Incorporating a Partnership to Form a Real Estate Investment Trust"

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The Real Estate Tax Digest
August 1, 1999

Originally published by Matthew Bender; 17 ***The Real Estate Tax Digest*** 8, 255 (Aug. 1999).

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Real estate investment trusts generally may not be incorporated by multiple transferors tax-free because section 351[1] is inapplicable to transfers to investment companies under section 351(e).

Section 351(a) generally allows a transfer of property to a corporation by one or more persons in exchange for the corporation's stock without recognition of gain or loss if immediately after the exchange the transferors are in control of the corporation.[2] However, section 351(a) does not apply to a transfer of property to an investment company.[3] The regulations provide that a transfer of property will be considered to be a transfer to an investment company if:

1. The transfer results, directly or indirectly, in diversification of the transferors' interests, and
2. The transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.[4]

A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in the exchange.[5]

Thus, if a sponsor of a new REIT were to incorporate multiple partnerships owning real property, diversification would occur and the incorporation would fail to meet the requirements of section 351. The umbrella partnership REIT (UPREIT) was introduced to avoid this and other problems of incorporating partnerships to form a REIT.[6]

However, for existing publicly traded real estate partnerships and other large real estate partnerships it is still possible to incorporate tax-free under section 351(a). Consider the typical publicly traded real estate partnership. It usually has a "holding company" limited partnership ("Parent Partnership") that is publicly traded. The Parent Partnership usually owns 99% of a subsidiary limited partnership ("Subsidiary Partnership") of which the Parent Partnership's general partner or a subsidiary of the Parent Partnership's general partner is a 1% general partner. The partnership can become a REIT as follows: (i) the sponsor organizes a new corporation (the "REIT"); and (ii) the Parent Partnership merges under state law into the REIT, receiving shares of REIT which are simultaneously distributed to Parent Partnership's partners.[7] Alternative methods of incorporating are possible. For example, in PLR 980106[8] a reverse triangular partnership merger was used. A REIT formed a new partnership with its wholly owned corporate subsidiary and merged the new partnership into the Parent Partnership. Parent Partnership then merged into Subsidiary Partnership.

Rev. Rul. 84-111[9] considered three alternatives for the incorporation of a partnership:

Situation 1. The partnership transfers its assets to the corporation in exchange for stock and the partnership liquidates, distributing the stock to its partners.

Situation 2. The partnership liquidates and the partners contribute the distributed partnership assets to the corporation in exchange for stock.

Situation 3. The partners exchange their partnership interests for the corporation's stock and the partnership liquidates into the corporation.

The Internal Revenue Service ("Service") ruled that it would follow the actual form of the transaction to determine the federal income tax consequences of the incorporation, which can be different in each situation.

The merger of Parent Partnership into the REIT is not specifically described in Rev. Rul. 84-111. However, it should follow the rules applicable to Situation 1, which seems to be most analogous. The Service has ruled privately that a merger of a partnership into a REIT is treated as through described in Situation 1 of Rev. Rul. 84-111.10

This method of incorporation should not violate the investment company limitations of section 351(e) because there is no diversification of the partners' interests. It is of interest to note that the Service has ruled privately, without discussion, that a simultaneous public offering of REIT stock for cash at the time of the incorporation of a partnership as a REIT will not be considered a transfer to an investment company.11

Before an incorporation is undertaken an analysis must be made as to the effects of section 357. Under section 357(c), if the sum of the amount of liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property contributed to the REIT, such excess is recognized as gain.12 Gain recognition under section 357(c) is another reason that UPREITs are popular. In a properly structured contribution to an UPREIT the contributing partner can usually avoid gain recognition completely.13

The Parent Partnership and its partners will avoid having the REIT stock treated as money to the partners pursuant to section 731(c)14 provided that the requirements of Treas. Reg. § 1.731-2(d) are satisfied. Generally, this regulation requires that the REIT stock be acquired in a nonrecognition transaction (e.g. section 351) and that:

1. The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction be less than 20 percent of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and
2. The partnership distributes the REIT stock within five years of either the date the REIT stock is acquired by the partnership or, if later, the date the security became marketable (which should not be an issue in the merger described above because the stock is distributed in the merger transaction).

If the Subsidiary Partnership's general partner is a limited liability company, is owned by the Parent Partnership's general partner, and all of its membership interests are acquired by the REIT in the incorporation procedure, the Subsidiary Partnership will be deemed to terminate for federal income tax purposes. While the Parent Partnership owns the limited liability company, the existence of the limited liability company will be ignored for federal income tax purposes (assuming an election has not been made for the limited liability company to be taxable as an association taxable as a corporation).15 Thus when the REIT acquires all the limited partner interests in the Subsidiary Partnership and the interest in the limited liability company general partner (which continues to be ignored), the Subsidiary Partnership will have only one partner and thus is also ignored for federal income tax purposes.16

If the Subsidiary Partnership's general partner is a corporation and is not converted to a limited liability company, the Subsidiary Partnership will continue to exist as a partnership for federal income tax purposes. Under Treas. Reg. § 1.856-3(g) the REIT will be deemed to own its proportionate share of each of the assets of the Subsidiary Partnership and will be deemed to be entitled to the income of the Subsidiary Partnership attributable to such share. This regulation also provides that where the Subsidiary Partnership sells real property, any gross income realized from such sale, to the extent that it is attributable to the real property, will be deemed gross income from the sale or disposition of real property held for either the period that the Subsidiary Partnership has held the real property or the period that the REIT was a member of the Subsidiary Partnership, whichever is the shorter. In analogous situations the Service has ruled that the holding period of the REIT's interests in the Subsidiary Partnership will include the holding period of the Parent Partnership based upon sections 362 and 1223(2).17

1 Unless indicated otherwise, all section references are to the Internal Revenue Code of 1986, as amended.

2 Section 368(c) defines control as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

3 IRC § 351(e). The application of section 351(e) was expanded by the Taxpayer Relief Act of 1997, but the application to these situations was not substantially modified.

4 Treas. Reg. § 1.351-1(c)(1).

5 Treas. Reg. § 1.351(c)(5).

6 See Bennett I. Deutsch, *UPREITs - How Much Gain Does a Partner Have if a Partner Does Have Gain?,* 9 Tax Mgmt. Real Est. J. 183 (1993) and Steven F. Mount, *Tax Checklist for Formation of UPREIT,* 35 Tax Mgmt Memo. 51 (Feb. 7, 1994).

7 Several states allow the merger of a limited partnership into a corporation. *See, e.g.*, Del. Code Ann. tit. 8, § 263 (1999).

8 PLR 9801016 (Sept. 30, 1997).

9 1984-2 C.B. 88.

10 PLR 9801016 (Sept. 30, 1997). While private letter rulings by statute may not be relied upon or otherwise cited as precedent by taxpayers other than the one that is the subject of a particular ruling, they do provide guidance as to the position of the Service on the subjects addressed therein. See IRC § 6110(k)(3).

11 PLR 9801016 (Sept. 30, 1997).

12 One should also consider the effect of section 357(b). Under section 357(b) if the assumption of a liability by the REIT is for the principal purpose of avoiding Federal income tax on the exchange, or was not a bona fide business purpose then gain is recognized to the lesser of the gain realized and the liability assumed.

13 *See* Deutsch, note 6.

14 Section 731 provides that on a distribution by a partnership to a partner gain is not recognized by the partner, except to the extent any money distributed exceeds the adjusted basis of such partner's interest in the partnership. Certain marketable securities are treated as money.

15 Treas. Reg. § 301.7701-3(b).

16 Id.

17 Under section 362, the REIT's basis in its partnership interests in the Subsidiary Partnership is the same as the adjusted basis of the partnership interests in the Subsidiary Partnership in the hands of the Parent Partnership. Section 1223(2) provides that where a taxpayer acquires property in any manner and receives a carryover basis in that property (in whole or in part), the holding period of such property will include the period for which such property was held by the person from whom the property was acquired. *See also* PLR 9847017 (Nov. 20, 1998); PLR 9816024 (Apr. 17, 1998); PLR 8825112 (Mar. 30, 1998); PLR 9801016 (Sept. 30, 1997); and PLR 9409037 (Mar. 7, 1994).