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The IRS and Senator Warren Raise Concerns about Lodging and Health Care REITs

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I. Introduction

On September 3, 2024, Senator Elizabeth Warren (D-MA) sent a letter to the Internal Revenue Service (the "IRS") urging it to "increase enforcement scrutiny of REITs, especially large health and hospitality REITs that may be illegally claiming significant tax breaks while meddling in the operations of their tenants". In the letter, Senator Warren states that:

[T]axable REIT subsidiaries ("TRSs") have negotiated agreements with hotel operators that give the TRS the right to exert significant control over labor terms, including vetoing collective bargaining agreements negotiated with hotel workers and participating in negotiations with hotel employee labor unions.

...

I urge you to increase enforcement scrutiny of REITs, especially large health and hospitality REITs that may be illegally claiming significant tax breaks while meddling in the operations of their tenants.

Senator Warren's letter followed a public letter from the IRS to Senator Ron Wyden (D-OR), where the IRS states that:

[W]e have become aware that some in the industry have advocated the view that an appropriate structure is for [a] TRS to lease [a] qualified lodging facility from [a] REIT and indirectly operate the qualified lodging facility. Any TRS that implements such an approach will lose its tax status. That may cause its REIT owner to fail one or more of its qualification requirements. That in turn would cause the REIT to lose its tax status for five years, including the ability to deduct dividends paid to shareholders, and become fully subject to the corporate tax.

Indirect operation or management, as well as direct operation or management, of lodging facilities by a TRS violates the tax rules. The prohibition applies even when the TRS rents the facility from the REIT under the related-party rental exception and an eligible independent contractor is hired to manage and operate the facility on the TRS's behalf. Even under this structure, the TRS remains barred from directly or indirectly operating or managing the lodging facility.

Senator Wyden's letter to the IRS, which was the impetus for the IRS letter, has not been released.

TRSs that lease qualified lodging facilities and qualified health care properties from REITs and hire eligible independent contractors to manage and operate the facilities and properties often have the right to approve collective bargaining agreements entered into by the contractors with unions. We do not believe that these approval rights alone constitute the operation or management of the lodging or health care businesses. Participating in negotiations with unions on behalf of the facilities could, however, be an indicium of operation or management.

II. Background on TRSs and the Related-Party Rental Exception

REITs are passive vehicles that are limited in the services they can provide and the income they can earn—in exchange, if they distribute all of their taxable income, they are not subject to corporate-level income tax. TRSs are often used by REITs to provide the services and earn the income that the REIT cannot—the tradeoff is that income earned by the TRS is subject to the usual corporate level tax.

Generally, rents paid by a wholly owned TRS to its REIT parent do not qualify as “rents from real property” for purposes of the REIT income tests.[1] However, special rules apply to rents received by a REIT in respect of “qualified lodging facilities” and “qualified health care properties” leased to a TRS.[2] These rents do qualify as rents from real property if the facilities or properties are operated and managed by an eligible independent contractor[3] (an “EIK”) (the “related-party rental exception”).[4]

Under the related-party rental exception, a TRS cannot directly or indirectly operate or manage a lodging facility or qualified health care property. [5] Neither the statute, the regulations, nor any other authority provides clear guidance on what it means to directly or indirectly operate or manage a lodging facility or qualified health care property.

Although a lodging facility or qualified health care property must be operated and managed by an EIK, the TRS (i) may bear all of the expenses of operating the lodging facilities or health care properties pursuant to a management agreement and (ii) may receive revenues from the operation of the lodging facilities or health care properties, net of expenses for such operation and fees payable to the EIK pursuant to a management agreement.[6]Thus, it is common in these arrangements for the TRS to benefit from all gross income from the business and bear all of its operating costs, including salaries and other benefits payable to the EIK’s employees, and for the EIK to receive a fee for its services. Since the TRS bears all of the expenses incurred in the operation of the business it is also common for the TRS to have approval rights over operating budgets and other major decisions with respect to the lodging facility or health care property, including the right to approve collective bargaining agreements.

III. The Letters

The IRS letter is unusual. It cites industry sources without attribution, gives a vague, high-level description of certain disapproved conduct, and then asserts that a TRS that engages in that conduct violates federal tax laws. In particular, the asserted bad conduct is “indirect operation or management” of a lodging facility, which is a requirement already specified in the Code itself, although the letter also states that “as a general matter, a TRS is prohibited from managing the day-to-day operation of the lodging facility, which may include recruiting, hiring, daily supervision, and direction of the employees.” Overall, the IRS letter does not add much more information about the tax law requirements imposed on TRSs with respect to qualified lodging facilities.

The Warren letter references a specific REIT but does not indicate any specific conduct by that REIT that violates the REIT rules. Instead, it suggests broadly that TRSs that have the right to veto collective bargaining agreements or participate in negotiations violate the REIT rules—a topic that the IRS letter did not directly address.

IV. Conclusions

We do not believe that it is possible to draw any firm conclusions from the letters. We believe that the mere power to approve major contracts, including a collective bargaining agreement, is not the operation or management of a qualified lodging facility or qualified health care property. Negotiating a collective bargaining agreement is normally a function of management and therefore could be viewed as evidence of operation or management that would have to be considered with other facts.

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[1] Sec. 856(d)(2)(B).

[2] A “qualified lodging facility” is, in general, a hotel or motel without wagering facilities. Sec. 856(d)(9)(D). A “qualified health care property” is, in general, real property that is a hospital or other licensed facility that provides medical or nursing or ancillary services to patients and is operated by a provider that is eligible to participate in the Medicare program with respect to the facility. Sec. 856(e)(6).

[3] An EIK is an independent contractor who (i) is actively engaged in the trade or business of operating lodging or health care facilities, respectively, for a person who is not related to the REIT or TRS and (ii) must have a management contract with a TRS to manage a property. Sec. 856(d)(9)(A). An independent contractor must operate more than one facility to qualify as an EIK. Sec. 856(d)(8)(B); *see also* P.L.R. 2008-25-034 (March 17, 2018).

[4] Sec. 856(d)(8)(B).

[5] We note that the IRS has held that a TRS that (i) had no employees, (ii) did not participate in the operation or management of a facility, (iii) had no control over the employment of individuals providing services at the facility, and (iv) was managed by an EIK that had exclusive authority over persons providing services at a facility, including exclusive responsibility for the "selection, hiring, employment, retention, training, control, determination of benefits and compensation, discharge, and other terms of employment of all the individuals providing services" at the facility, was not considered to be directly or indirectly operating or managing a lodging facility in violation of section 856(l)(3)(A). P.L.R. 2015-33-006 (May 15, 2015). However, these were representations made by the taxpayer in the ruling, and while the IRS found these facts sufficient to establish that the TRS was not directly or indirectly operating or managing a lodging facility, the IRS did not state or otherwise hold that exclusive authority over all employment matters by an EIK is *required* in order for the TRS to not be considered to directly or indirectly operate a lodging facility or whether a TRS's retention of certain rights with respect to an EIK's employees, in particular matters affecting costs associated with employees that would be borne by the TRS, would be acceptable.

[6] Sec. 856(d)(9)(B).

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