Deferred compensation and real estate investment trusts (REITs)

A real estate investment trust (REIT) is a specially defined entity under the Internal Revenue Code (IRC).[1] A REIT is defined as a corporation, trust, or association that specializes in investments in real estate and real estate mortgages. Any entity that satisfies the IRC's gross income and diversification tests may elect to be taxed as a REIT. If the REIT passes the tests, it's entitled to a "dividends paid" deduction, which essentially eliminates the double taxation of REIT profits to shareholders.

REITs are subject to the requirements set forth in IRC Sections 856 and 857. These rules are very complex and specify the required interactions between taxable income, dividends paid to shareholders, and assets held for investment.

From the tax code:

- **Two income tests**. (1) At least 95% of gross income must be from dividends, interest, rents from real property, gains from sales of stocks, securities, and real property. (2) At least 75% of gross income must come from rents, interest on mortgages, gains from sales of real property and mortgages, and other real estate activities. A tax is imposed on REIT income if these tests are not met.

- **Asset test**. At the end of each quarter, at least 75% of the REIT's total assets must be in the form of real estate, mortgage interest, cash and receivables, and government securities.

- **Taxation**. As long as a REIT distributes at least 90% of its taxable income, it receives a 100% dividends-paid deduction for distributed amounts and pays regular corporate tax rates on remaining taxable income, thus avoiding double taxation to the shareholders. The REIT may internally retain capital gains, but the REIT must pay tax on those gains. The capital gain and a credit for the tax paid by the REIT flow through to the shareholders.

REITs and Deferred Compensation:

When a REIT establishes a nonqualified deferred compensation plan, the following issues should be taken into account by the sponsoring REIT.

Employee deferrals are not currently tax deductible by the employer. Therefore, to satisfy the 90% distribution rule, more income may need to be distributed to shareholders, under certain circumstances. Employee deferrals do not impact the income tests discussed above because those tests are based on gross income, not net profits.

Plan financing serves the purpose of providing a sinking fund to pay promised benefits. These invested assets mirror the deemed investments provided to plan participants and may provide cost recovery for the program. It is important to consider the impact of financing strategies.

- **Taxable asset financing**. Mutual funds will generate taxable interest and dividend income. Under the 95% **income** test, dividends and interest are includible as income. For tax purposes, any realized interest and dividends will increase taxable income. The result may be that 90% of this realized income will be paid out to shareholders in the form of cash dividends, while any remaining amounts would be taxable to the REIT. This may cause the plan to be under-financed and result in variability on the income statement.

- **Corporate-owned life Insurance (COLI) financing**. There are several benefits for using COLI to informally finance deferred compensation plans. First, any increases in surrender value of COLI are not currently taxable and have no impact on any REIT income and distribution tests. Second, the death benefit will generally be received by the REIT income tax free and may provide both key person protection and cost recovery. In addition, because proceeds do not have to be distributed, the value of REIT shares would generally increase. This may cause the plan to be better financed and result in less variability on the income statement. However, it's important to consider policy expenses along with benefits of using COLI financing.

Summary

- Deferred compensation plans, in general, may increase the amounts required to be distributed to shareholders under certain circumstances due to the 90% test.
- Taxable asset financing may also cause an increase in the amount distributed to shareholders as a result of realized taxable income.
- COLI financing won't affect the income tests or increase the distributable amount to shareholders. In addition, there won't be additional tax on the build-up in the cash surrender value.

1 See IRC Section 856(a).

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