IRS and Two U.S. Senators Question Involvement of Hotel REITs in Negotiating Collective Bargaining Agreements

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Hotel management agreements (HMAs) frequently include provisions giving hotel owners rights to influence management companies' negotiations of collective bargaining agreements (CBAs) with unions, and even requirements that a CBA be approved by an owner before a management company may sign it. Owners' motives underlying these provisions are understandable. A collective bargaining agreement can have both an immediate effect on a hotel's profit margins and a longer-term effect on its salability and market value.

This year, two U.S. Senators and the U.S. Internal Revenue Service (IRS) have proposed that if a hotel owner is a real estate investment trust (REIT), it may lose eligibility for federal tax advantages if it exercises such control over its management company's CBA negotiations.

Some Background on Real Estate Investment Trusts

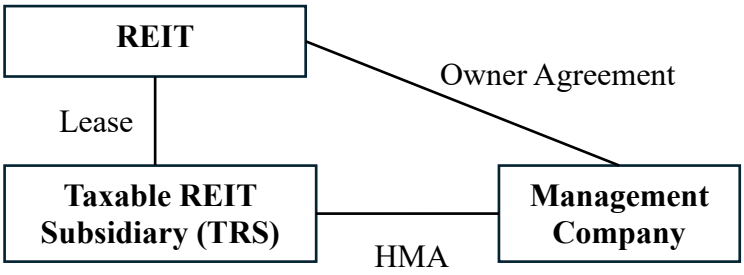
The precise definition of the term "real estate investment trust" appears in Section 856(a) of the Internal Revenue Code. In a nutshell, a REIT is a business entity that earns the vast majority of its income from some form of real estate investment, and that meets certain other requirements. Structuring a real estate investment company as a REIT exempts the company from most corporate income tax while also (at least until the end of 2025) providing investors in the REIT a limited deduction on its dividends. Congress created this vehicle to make it easier for average investors to participate in large-scale real estate investments.

The tradeoff for the tax advantages of a REIT are certain restrictions, the most important of which limit the source of a REIT's income to real estate investment. While a REIT's income can include "rents from real property," 26 U.S.C. § 856(c)(2)(C) and (3)(A), the presumption is that those rents cannot be "received or accrued directly or indirectly" from a tenant-business in which the REIT holds an interest. *Id*. § 856(d)(2). Therefore, a company in the business of selling widgets could not exempt itself from otherwise-applicable corporate income tax by holding its widget business in a subsidiary, leasing space to the subsidiary, and collecting the subsidiary's profits as tax-exempt rent.

However, there are exceptions to this presumption. Certain categories of REITs are allowed to collect rent on a tax-advantaged basis from "taxable REIT subsidiaries" (TRSs) if certain requirements are met. *Id*. § 856(d)(8). One of these exceptions is for a "qualified lodging facility . . . leased by the [REIT] to a taxable REIT subsidiary of the [REIT] if the property is operated on behalf of such subsidiary by a person who is an eligible independent contractor." *Id*. § 856(d)(8). A "qualified lodging facility" is basically a hotel without a casino. *Id*. § 856(d)(9)(D). An "eligible

independent contractor" is basically a hotel management company that operates hotels for owners with which it is not affiliated. *Id*. § 856(d)(9)(A).

Large hotel owners have flocked to this exception, entering into triangular relationships among REITs, taxable REIT subsidiaries and unaffiliated management companies.



Within this structure, the taxable REIT subsidiary enters into a hotel management agreement with an unaffiliated management company. The TRS' income from the hotel is paid to the REIT in the form of rent, on a tax-advantaged basis. The TRS' obligations under the management agreement are guaranteed by the REIT under a separate "Owner Agreement." The terms of hotel management agreement are substantially the same as they would be if the TRS held title to the hotel, even referring to the TRS as "Owner."

As noted above, frequently these terms include a requirement that "Owner" have some involvement in the management company's negotiations of collective bargaining agreements, and even a right of approval of any CBA.

The Challenge

This practice was challenged this year, in a coordinated effort among Senator Elizabeth Warren (D-MA), Senator Ron Wyden (D-OR) and the IRS. Some in the hotel industry believe that this effort was organized by UNITE HERE, the country's largest hotel employees' union, which led strikes at hotels nationwide at about the same time.

On August 26, 2024, IRS Chief Counsel Marjorie A. Rollinson responded to an unpublished inquiry by Senator Wyden with a public letter. The letter does not mention CBAs specifically. Rather, it expresses a more general position that even if a TRS is a qualified lodging facility, it "may not directly or indirectly operate or manage [the] lodging facility." The following are the most substantive paragraphs of the letter:

> The law is clear that a TRS may not directly or indirectly operate or manage a lodging facility. If it does, it will lose its special tax status with potentially severe adverse tax consequences for its REIT owner. If a REIT and TRS avail themselves of the exception to the related party rent rule . . . operation and management of the qualified lodging facility must be performed by the eligible independent contractor.

> Whether the activities of a TRS constitute the direct or indirect management and operation of a lodging facility depends on facts and circumstances. However, 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.
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> Unfortunately, we have become aware that some in the industry have advocated the view that an appropriate structure is for the TRS to lease the qualified lodging facility from the 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.
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> 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.

One week later, on September 3, 2024, Senator Warran sent a public letter to IRS Commissioner Daniel Werfel that echoes the IRS' concerns and specifically mentions TRS participation in CBA negotiations. Senator Warren's letter quotes extensively from Ms. Rollinson's letter and encourages the IRS to "increase scrutiny of potential violations of tax law by Real Estate Investment Trusts[.]" Senator Warren notes that "REITs must follow tax rules that bar them from managing lodging facilities" and faults "taxable REIT subsidiaries (TRSs) [for] negotiat[ing] 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."

It remains to be seen how much influence these letters will have over the next few years, given the results of the 2024 presidential election. Nevertheless, hotel REITs have taken note and are paying closer attention to HMA language governing owner involvement in negotiating CBAs.

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