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MLPs, REITs and S&P's New Real Estate Sector Classification

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On September 1, 2016, Standard & Poor's (S&P) upgraded real estate as a stand-alone sector within its Dow Jones Global Industry Classification Standard (GICS). GICS is the de facto classification system for equity securities worldwide. The first reclassification of its kind since the launch of the GICS in 1999, this formal recognition of real estate as a sector separate from the GICS's larger financial sector underlines the importance of real estate (and real estate investment) as a pillar of the United States' economy and overall Gross Domestic Product (GDP).

As the GICS is intended to track the performance of public companies, the newly created real estate sector will largely be comprised of public Real Estate Investment Trusts (REITs). However, the GICS's real estate sector will not include public real estate Master Limited Partnerships (MLPs). This omission is somewhat surprising, given the similarities between REITs and MLPs. Because both REITs and MLPs generally do not pay income taxes themselves, they are often used as vehicles to finance large-scale real estate portfolios. This article seeks to describe the key differences between REITs and MLPs, in order to further understand why MLPs may have been excluded from GICS's new real estate sector.[1]

History

MLPs: MLPs are about 35 years old, created when Ronald Reagan signed the current revision of the Internal Revenue Service's Internal Revenue Code (IRC) into law in 1986. As discussed further below, real estate MLPs are not (yet) eligible to be listed on S&P indices.[2]

REITs: REITs are about 56 years old, created when Dwight D. Eisenhower signed into law the United States' first REIT legislation in 1960. In 2001, REITs became eligible to join S&P indices and were originally placed under GICS's finance sector. As of September 1, 2016, REITs have now effectively been classified as their own sector of the economy in S&P's creation of the GICS real estate sector.

Tax Treatment

MLPs: While other publicly traded partnerships are taxable as a corporation, MLPs are taxed as partnerships, as at least 90 percent of their income is qualifying income under Section 7704 of the IRC. Qualified income for MLPs' purposes includes income from real estate rentals and from the sale of real estate. As a partnership, an MLP does not pay income taxes, but rather the MLP's income flows through to its partners, whom in turn pay tax on that income. MLPs must issue their partners Schedule K-1's for each year, and each partner is responsible for paying income tax on that partner's distributive share of the MLP's income. This responsibility can result in a complicated tax return which will generally require a sophisticated CPA to determine the correct amount of taxes owed by the investor and in which states such taxes must be paid.

On the other hand, distributions from an MLP are tax-free returns of capital to the extent that the MLP's distributions do not exceed a partner's tax basis in its interest in the MLP (which basis is adjusted upward as income is allocated to, and the relevant tax is paid by, the partner). Any distributions in excess of a partner's tax basis are generally taxed as capital gains.

REITs: REITs are governed under Sections 856 through 860 of the IRC. REITs are permitted a deduction for dividends paid to shareholders, which generally will offset any taxable income of the REIT itself. Each year, REITs send their investors a Form 1099-DIV, which is a straightforward form that provides the amount of tax to be paid by a shareholder based on the amount of distributions it received from the REIT. Distributions made by a REIT to its shareholders out of current or accumulated earnings of the REIT are taxed as ordinary income. However, distributions in excess of current and accumulated profits of the REIT are treated as returns of capital to shareholders, and therefore are taxed as capital gains, to the extent such distributions are in excess of the shareholder's adjusted tax basis.

Under the IRC, REITs are subject to many other restrictions on their organization, income, assets and distributions. For example, a REIT must generally have 75 percent of its income derived from real estate sources and 95 percent of its income from passive sources; at least 75 percent of a REIT's assets must consist of real estate assets and certain liquid assets; and a REIT must generally distribute 90 percent of its taxable income to its shareholders annually. MLPs do not have these kinds of restrictions, although they also must ensure that their income comes from qualified sources (such as rental income, as discussed above).

Distributions

MLPs: Management of a MLP will typically target a specific dividend rate in the MLP's organizational documents, but is free to change said target dividend rate (and the timing of payment of dividends), as long as such change is in line with the MLP's organizational documents. Also, MLP distributions are often tax-free as a result of the capital gains treatment discussed above. In other words, MLPs have greater flexibility than REITs with regard to distribution requirements.

REITs: As discussed above, REITS must pay dividends equal to 90 percent of their taxable income to shareholders in order to meet their annual distribution requirements. Thus, REITs typically declare regular dividends to ensure compliance. Further, such dividends are likely to be taxed as ordinary income, rather than as capital gains.

Investor Requirements

MLPs: MLPs have fewer restrictions on the number of investors in the MLP than REITs do, but institutional investors such as mutual funds and pension funds have certain statutory limitations regarding ownership of MLP securities.

REITs: REITs must be held by at least 100 investors and may not be closely-held, meaning that not more than 50 percent in value of the stock of a REIT can be held by five or fewer individuals.

Corporate Governance

MLPs: Investors in MLPs are limited partners and generally do not have control over how the general partner of the MLP operates the affairs of the MLP.

REITs: Public REITs are governed by a board of directors, which the REIT's shareholders elect, thereby directly influencing the way the affairs of the REIT are operated. Some public REITs also have an external management company that is also publicly traded, the shares of which can also be owned by a shareholder in the corresponding REIT, providing even more voting power over the operation and control of the REIT.

Leverage

MLPs: MLPs have less access to debt markets and typically operate at three and one-half to four and one-half times leverage.

REITs: REITs have considerably more access to the debt markets and therefore often operate at five to six times leverage. This can mean that REITs are more sensitive than MLPs to interest rate fluctuations and rapid changes in the overall economy.

Conclusion

Both MLPs and REITs operate with the purpose of returning capital to investors, both through regular distributions and a gain in value of assets over time, while simultaneously minimizing taxes on such distributions and asset gains. MLPs represent a more flexible, less-leveraged vehicle for investors than REITs. However, MLPs afford less control over the entity's affairs. Also, because there are considerably fewer public, real estate MLPs than public REITs, MLPs are likely less liquid, as MLPs are not bought and sold by large numbers of investors like REITs currently are. Further, making liquidity more difficult, real estate MLPs are not yet listed on indices such as the GISP.

It took REITs more than 40 years to be accepted on the S&P and an additional 15 years to grow into a separate sector. It will be interesting to see if real estate MLPs, with their subtle differences from REITs, can achieve such widespread recognition and earn a place on an index such as the GISP as a separate sector, like REITs have, or perhaps become considered a part of the GICS's real estate sector. Until that aggregation occurs, however, investors would be well-adjusted to understand the key similarities and differences between these two distinct means of investing in public real estate investment vehicles.

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[1]For reasons outside the scope of this article, we note that Mortgage REITs are also excluded from the S&P's real estate sector.

[2]We note that certain energy sector MLPs are listed on S&P indices, however.