NAREIT
National Policy Bulletin

REIT AND REAL ESTATE RELATED ITEMS IN THE ADMINISTRATION'S FISCAL YEAR 2001 PROPOSED BUDGET

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Introduction

In its proposed budget for Fiscal Year 2001, the Administration recommends making several changes that would affect real estate. As with the past few budgets, the Republican Congressional Leadership has indicated that it would view the Administration's revenue-raising proposals with great skepticism, and it is far from clear whether any of them have a realistic chance of being adopted. Moreover, the politics arising from a major election year cloud the chances of both sides of the aisle agreeing on any tax legislation this year. This National Policy Bulletin summarizes the Administration's proposals that affect real estate. Further details can be found under the government relations section of www.nareit.com.

Increased Distribution Requirement to Avoid the 4% Excise Tax

Background. Under current law, to maintain their tax status, REITs are required to distribute 95% of their taxable income while mutual funds are required to distribute 90% of taxable income. The Tax Relief Extension Act of 1999 (the "1999 Act") reduced the distribution requirement for REITs from 95% of taxable income to 90% of taxable income for taxable years beginning after December 31, 2000.

In addition to the distribution requirement necessary to maintain their tax status, both REITs and mutual funds are subject to a 4% excise tax on the difference between their "required distribution" for a calendar year and their "distributed amount" for that year. For REITs, the required distribution under current law equals the sum of 85% of "ordinary income" for the calendar year (essentially, REIT taxable income for the year without reduction for the dividends paid deduction and without reference to capital gain or loss) plus 95% capital gain net income for that calendar year. For mutual funds, the required distribution equals 98% of a mutual fund's "ordinary income" plus 98% of its capital gain net income.

For example, a REIT that generates $100x in ordinary income in 1999 must distribute at least $95x to its shareholders to receive a dividends paid deduction for 1999. However, if a REIT makes an election under I.R.C. § 858, the Code treats as paid in 1999 any dividend declared before it files its tax return (due, with extensions, on September 15, 2000) and paid in 2000 before its first regular dividend payment date after such declaration. To avoid the 4% excise tax for 1999, the REIT must distribute at least $85x during 1999 or, under the "look back" rule of I.R.C. § 857(b)(8), in January of 2000 if the dividend is declared in the last quarter of 1999.

New Proposal. The Administration proposes that in order to avoid the 4% excise tax, the REIT's required distribution would be increased to the sum of 98% of its ordinary income and 98% of its capital gain net income. The Administration believes that this provision is necessary in order to conform the REIT excise tax to the mutual fund excise tax.

Effective Date. The proposal would be effective for calendar years beginning after December 31, 2000.

Revenue Raised. The Administration estimated that this provision would raise $4 million over five years.

NAREIT Position. NAREIT believes that while REITs were modeled after mutual funds, practical operational considerations require that some rules be distinct. The increased distribution proposal would eliminate much of the benefits of Congress' decision to lower the 95% distribution requirement to 90%, and would ignore the special capital needs of REITs and the increased difficulties a REIT faces in accurately calculating its taxable income during a taxable year. Accordingly, NAREIT will oppose this provision vigorously.

Re-proposed Closely-held REIT Rules

As in previous Budgets, the Administration proposes a "closely held REIT" ownership test under which no entity (regardless of its ultimate ownership) could own 50% or more of a REIT's stock (by vote or value).

- As in the Fiscal Year 2000 Budget, the Treasury Department recommends that this test not apply to a REIT owning 50% or more of another REIT. This exception would be consistent with the general REIT tests under which REIT stock is considered a "real estate asset." The exception would make sense because ultimately the REIT owning the majority interest in another REIT would have to satisfy the new ownership test.

- For the first time, the Administration supports a "limited look-through rule" for partnerships that own 50% or more of a REIT. We understand that this exception would allow a partnership that makes pro rata allocations to own 50% or more of a REIT's stock.

- While there is no exception for a private REIT formed with the intention of going public within a few years (an "incubator REIT"), the Administration informally acquiesced last year to a proposed "incubator REIT" exception to its closely held REIT proposal, and we understand that this policy has not changed. Similarly, we understand that the Administration would not oppose an exception for a domestic pension plan that owns 50% or more of a REIT's stock. Finally, there is no exception for publicly traded REITs.

Effective Date. As in its Fiscal Year 2000 Budget, the Administration proposed that this new test apply to entities electing REIT status for taxable years beginning on or after the "date of first committee action." Similar to last year's proposal, the Administration also would apply the new ownership test to an entity electing REIT status for a taxable year before first committee action if it does not have "significant" business assets or activities as of such date. Thus, REITs created last year with significant business activities or assets by the date of first committee action this year would be grandfathered.

Revenue Raised. In last year's Budget, the Administration estimated that the proposal would raise $75 million over five years. In this year's Budget, the Administration estimates that the proposal would raise $42 million over five years, presumably because the estimated tax rules for closely held REITs were enacted in December.

NAREIT Position. NAREIT supports the Administration's goal of ensuring that REITs provide an accessible method for ordinary investors to invest in commercial real estate enterprises. While generally supporting the Treasury Department's proposed new ownership test, NAREIT believes that the test should be more narrowly tailored to any perceived corporate tax abuse.

NAREIT looks forward to working with Congress and the Administration as they craft rules to address any perceived abuse, while maintaining investor accessibility to REITs. NAREIT suggests three changes to accomplish these goals. First, the rules should not apply to private REITs that intend to access the public markets after they have created a track record during their "incubation" stage. With only some minor technical changes, we support the incubator REIT exception that was included in the tax bill that the President vetoed for other reasons last September.

Second, the rule should not apply to a domestic pension plan owning 50% or more of a REIT's stock, as Congress in 1993 enacted I.R.C. § 856(h)(3)(D) to address any issues in this area.

Third, the rule should apply only to non-REIT C corporations owning 50% or more of a REIT's stock, since the tax strategies being targeted by the Administration only involve such ownership patterns. At the very least, there should be some type of exception for any entity that owns common stock of a publicly traded REIT.

No Re-Proposal of Built-in Gains

Background. In the previous three proposed Budgets, the Administration had advocated imposing a double level tax when a C corporation worth more than $5 million elects or merges into an S corporation, mutual fund or REIT. Under the proposal, the excess of the value of the C corporation's assets over their tax bases (the "built-in gain") would have been subject to both a corporate and shareholder level tax, as if the corporation had liquidated. Congress has never seriously considered this proposal, and last year House Ways and Means Chairman Bill Archer (R-TX) pronounced it as "dead before arrival."

No mention of the built-in gains tax is made in the Fiscal Year 2001 Budget. Instead, on February 7, 2000, the Treasury Department issued regulations implementing a twelve-year old IRS Notice (Notice 88-19) that indicated the IRS' plan to issue regulations that would require C corporations (regardless of size) that elect REIT status, or merge into REITs, to pay tax on their built-in gain unless the REIT elected to pay tax on any gain recognized from the taxable disposition of the built-in gain assets during the 10-year period after the conversion or merger.

NAREIT Position. NAREIT had opposed the Administration's prior proposals to change these built-in gain rules, and we are gratified that the Administration now supports the existing rules that apply when a C corporation elects REIT status. Moreover, NAREIT is pleased that after a twelve year wait, the IRS has issued the regulations to implement Notice 88-19. However, because the regulations apply to closed tax years, NAREIT is concerned that they may pose traps for the unwary. A more detailed explanation of the new regulations will be sent to members who have requested receipt of IRS REIT Guidance. NAREIT is forming a task force to prepare and submit comments on the regulations. If you are interested in participating on this task force, please contact Dara Freedman at dfreedman@nareit.com before February 18.

Recognition of Gain on Contributions of Appreciated Property to Swap/Exchange Funds

Background. Under current law, gain is deferred on the contribution of appreciated property to a partnership so long as 20% or more of its assets are not "readily marketable stocks or securities." Real estate clearly is not considered readily marketable stocks or securities, and neither are most common and preferred Operating Partnership ("OP") units. Thus, several sponsors of "swap" (or "exchange") funds designed to permit a taxpayer to diversify his or her stock position on a tax-deferred basis have contributed cash to OPs in exchange for limited partnership preferred units, typically exchangeable after seven or more years into REIT preferred stock. Since the OP units are more than 20% of the exchange fund's assets, contributions of appreciated stock to the fund are not currently taxed.

Last year, Rep. Richard Neal (D-MA) proposed a bill (H.R. 2705) that would have required taxpayers who contribute appreciated property to a partnership or limited liability entity to recognize gain on the contribution.

New Proposal. The proposal would add limited and preferred interests in partnerships to the list of readily marketable securities. Also, the proposal would require a taxpayer to recognize gain upon the transfer of marketable stock or securities to a corporation or partnership that is essentially a "passive investment vehicle." The proposal would except certain transfers of already diversified pools of stocks and securities. The proposal does not appear to affect the formation of typical UPREITs or DownREITs.

Effective Date. The proposal would be effective for transfers occurring on or after the date of enactment.

Revenue Raised. The Administration estimates this proposal to raise $36 million over five years.

Proposed Codification and Expansion of Fast Pay Stock Regulations

Background. In Notice 97-21, the IRS alerted taxpayers that it intended to issue regulations concerning transactions involving self-amortizing stock (also known as "fast pay" stock). In these transactions, a "conduit entity," like a non-traded REIT, would issue preferred stock to a non-taxable entity (like a pension trust) and common stock to a "sponsor." Under the "fast-pay" structure, the REIT preferred stock dividend rate was accelerated in the early years (and all of the dividend was deducted by the REIT) at an above market rate. During this "fast pay" period, little or no dividends were paid to the sponsor. The IRS viewed the REIT's preferred stock as the equivalent of self-amortizing debt from the tax-exempt shareholders to the sponsor, and in January issued final regulations regarding these transactions. Under the final regulations, transactions involving fast pay stock are recharacterized as arrangements directly between the tax-exempt shareholders and the sponsor. Thus, the existence of the REIT is ignored. In finalizing these regulations, the IRS noted that some commentators thought a legislative solution would be better as amatter of tax policy.

New Proposal. Although the Administration believes that the fast pay regulations issued by the IRS appropriately responded to the fast pay stock transactions in the domestic context, the Administration also believes that legislation limiting the dividend characterization on self-amortizing stock is a better "long-term solution," particularly in the foreign context. Accordingly, the proposal provides that, in the case of a distribution with respect to self-amortizing stock issued by a conduit entity, the amount treated as a dividend shall not exceed the amount of the distribution that would have been characterized as a payment of interest had the self-amortizing stock been a debt instrument.

Revenue Raised. This proposal would raise $180 million over five years.

Effective Date. The proposal would be effective for distributions with respect to "self-amortizing" stock made after the date of enactment.

Permanent Expansion of Deductions for "Brownfields" Expenses

Background. Under the Taxpayer Relief Act of 1997, certain remediation costs are currently deductible if incurred with respect to a "qualified contaminated site" (a "Brownfields" site). As part of the Tax Relief Extension Act of 1999, this provision was extended for one year to allow deductions for expenditures paid or incurred on or before December 31, 2001.

New Proposal. The proposal would extend permanently the ability to deduct remediation expenses for Brownfields sites.

Revenue Cost. The Administration estimates that the five-year cost for this provision would be $536 million.

NAREIT Position. NAREIT applauds the Administration for proposing a permanent extension of current deductions for Brownfields remediation expenses. In addition, NAREIT encourages the Administration and other policymakers to consider the tremendous potential remediation that could occur at contaminated sites if the extension were expanded to properties that do not currently fit within the definition of a "qualified contaminated site."

Future Action. It is important to remember that the Administration's proposed Budget is but the first step in the legislative process. Congress now must agree to broad parameters for the Fiscal Year 2001 budget, including taxes and spending. Looming large on the horizon is how Congress will address the projected budget surpluses, as well as related issues such as Social Security, Medicare, defense spending and tax cuts. Only after Congress has approved the blueprints of an overall budget will the tax-writing committees likely start considering any broad tax legislation.

We will keep you advised of important legislative developments as they occur. If you would like to discuss these proposals in greater detail, contact Tony Edwards or Dara Freedman in NAREIT's Government Relations Department at 800-3NAREIT or tedwards@nareit.com or dfreedman@nareit.com.