

REITS MODERNIZED

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INTRODUCTION

Congress created REITs in 1960 to allow people from all walks of life to invest in a diversified, professionally-managed real estate enterprise. Like today's software companies, Congress repeatedly has "upgraded" the original operating systems for REITs, most notably in 1976, 1986, 1993 and 1997. On December 17, 1999, as part of a larger bill¹ President Clinton signed into law legislation (the REIT Modernization Act, or "RMA") containing several provisions that, when effective in 2001, will allow REITs to compete on a more level playing field and carry out their business plans with greater efficiencies.² The RMA originally was introduced by two-thirds of the House Ways and Means Committee³ and three-quarters of the Senate Finance Committee⁴.

NAREIT strongly supported the RMA and worked closely with policymakers to obtain its passage⁵. The REIT industry congratulates Congress and the President for enacting the RMA and greatly appreciates the efforts all parties exerted to achieve this new milestone in the evolution of REITs. These changes are necessary to revitalize the REIT structure to better serve REIT investors and the American economy for the next 40 years of the REITs' charter.

EXECUTIVE SUMMARY

Taxable REIT Subsidiaries. The RMA will allow a REIT to own up to 100%⁶ of the stock of a taxable REIT subsidiary ("TRS") that can provide services to REIT tenants and others without disqualifying the rents that a REIT receives from its tenants. The RMA contains size limits on a TRS to ensure that a REIT remains focused on core real estate ownership and operations. To ensure that a TRS is subject to an appropriate level of corporate taxation, the amount of debt and rental payments from a TRS to its affiliated REIT will be limited. Further, a 100% excise tax will be imposed to the extent any transaction between a TRS and its affiliated REIT (or that REIT's tenants) is not conducted on an arms' length basis. A TRS may not operate or manage lodging or health care facilities, but a TRS may lease lodging facilities from its affiliated REIT at market rates so long as an independent contractor operates and manages the facilities. After the 2001 effective date, a REIT will not be able to own more than 10% of the vote **or value** of the securities of a non-REIT C corporation (other than securities of a TRS, certain debt securities, and securities of "grandfathered" entities described below).

The RMA restrictions on TRSs will not apply to arrangements in place (including third party subsidiaries) as of the date of introduction so long as the subsidiary does not engage in a new line of business, its existing business assets do not increase, and the REIT does not acquire any new securities in the subsidiary.

Distribution Requirement. The RMA will return the REIT distribution requirement from 95% to the 90% level currently applicable to mutual funds and that applied to REITs from 1960 to 1980.

¹ Including REIT provisions in a larger tax bill has become a well-entrenched tradition, starting from when the original 1960 REIT legislation was incorporated into a cigar excise tax bill.

² Sections 541-71 of Pub. L. No. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999. See H.R. Rep. No. 478, 106th Cong., 1st Sess. 175-81 (1999); S. Rep. No. 201, 106th Cong., 1st Sess. 55-65 (1999). These provisions are substantially similar to sections of the Taxpayer Refund and Relief Act of 1999, which President Clinton vetoed on September 23, 1999. See H.R. Rep. No. 289, 106th Cong., 1st Sess. 375-80, 518-20 and 534-35 (1999). For more background information, see the Government Relations section of www.nareit.com.

³ See H.R. 1616. The lead sponsors were Reps. Bill Thomas (R-CA) and Ben Cardin (D-MD).

⁴ See S. 1057. The lead co-sponsors were Sens. Connie Mack (R-FL) and Bob Graham (D-FL).

⁵ NAREIT appreciates the following real estate associations that endorsed the RMA: the American Resort Development Association, the American Seniors Housing Association, the International Council of Shopping Centers, the Mortgage Bankers Association of America, the National Apartment Association, the National Association of Industrial and Office Properties, the National Association of Realtors, the National Multi Housing Council, and The Real Estate Roundtable.

⁶ A corporation can elect (along with a REIT) to be a TRS no matter how small the REIT's ownership interest in that corporation. For example, a REIT might decide to own 10% of a corporate joint venture in which the majority partner has more experience in providing specific services.

Personal Property Rents. The RMA will change the measurement of the REIT 15% personal property rule from adjusted tax basis to fair market value.

Health Care REITs. The RMA will allow a REIT to hire an independent contractor to operate nursing homes, etc. without a lease for up to six years when the REIT takes back a health care property at the end of a lease and cannot re-lease it. This rule will extend the “foreclosure property” rules, under which a REIT pays corporate taxes on the operating income from such property for a limited period until it can secure a new lease. In addition, pre-existing arrangements with respect to other properties will be disregarded in testing whether an entity qualifies as an independent contractor for health care properties using the foreclosure property rules.

Definition of Independent Contractor. In the case of a publicly traded corporation being tested as an independent contractor, the RMA only will examine shareholders owning more than 5% of the corporation’s stock.

Earnings & Profits Rules. To prevent some traps for the unwary, the RMA will make some technical changes about how a company computes pre-REIT earnings and profits that it must distribute to its shareholders after electing REIT status or merging with a C corporation.

TAXABLE REIT SUBSIDIARIES

Background

Additional Services to Tenants. Since 1986, income that REITs derive from providing customary services to their tenants has been considered rents from real property that meets both the 95% and 75% gross income tests. The Taxpayer Relief Act of 1997 adopted a useful rule under which a small amount of non-customary services that a REIT provides to a tenant does not disqualify the underlying rents that the tenant pays the REIT. However, if a REIT provides non-customary or tenant-specific services (*e.g.*, concierge services) to a tenant beyond a de minimus amount, the IRS contends that all payments from that tenant do not qualify under the relevant REIT tax tests. The IRS generally takes the position that this “tainting” effect also applies if the services are rendered by a REIT’s third party subsidiary.

Like other major businesses in the United States in recent years, the real estate industry has evolved into a customer-oriented service business. Landlords that provide new services to their tenants only after such services have become “usual and customary” risk losing their competitive edge in attracting and retaining top-quality tenants. Further, as REITs grow larger they automatically can affect what services are considered customary in a geographic locale. Paradoxically under prior law, some services might never have been considered customary because REITs were prevented from providing “leading edge” services.

In addition, all businesses have discovered that providing ancillary services with good quality controls produces both customer loyalty and additional income. Under the prior law, a REIT must use independent contractors to provide non-customary services to its tenants, so REIT management has had little control over the quality of the services rendered to the REIT’s tenants. Income from these new revenue-producing opportunities has had to accrue to the benefit of a third party, to the REIT shareholders’ detriment.

Thus, providing new services to tenants has three equally compelling benefits. First, the availability of the new service to the tenant generates greater customer loyalty and allows the REIT landlord to remain competitive.⁷ Second, the new service (offered either by the landlord or by a third party licensed by the landlord) generates a new stream of income for the REIT shareholders. Third, the REIT can maintain better quality controls over the services rendered to its tenants.

⁷ “Current law restrictions require REITs to adhere to unworkable distinctions that defy logic and impede competitiveness.” 145 Cong. Rec. E795 (Daily Ed. April 28, 1999)(remarks of Rep. Bill Thomas). See also 145 Cong. Rec. S5377 (Daily Ed. May 14, 1999)(Remarks of Sen. Connie Mack).

Services to Third Parties. Modern REITs have performed services for their tenants so well that third parties retain REITs to provide the same service. The original REIT legislation had permitted a REIT to earn up to 5% of its income from sources other than rents, capital gains, dividends and interest. However, many REITs have had the opportunity to maximize shareholder value by earning more than 5% from managing joint ventures and from other third party service income.

To capture part of this income flow, many REITs have invested in non-REIT C corporations (sometimes using some key REIT employees). These corporations provide to unrelated parties services already being delivered to a REIT's tenants (such as landscaping apartment complexes and managing a shopping mall in which the REIT owns a joint venture interest), or provide services not allowed to be offered by a REIT. Moreover, mortgage REITs have used non-REIT C corporations to make mortgage loans, purchase mortgage loans from third parties or from the REIT, and to service mortgage loans.

The REIT asset rules are patterned loosely after the asset diversification rules applicable to mutual funds. Under these rules, a REIT may not own more than 10% of the voting securities of another company (other than a "qualified REIT subsidiary" or another REIT), and the securities of another company may not exceed 5% of the value of a REIT's total assets.

To comply with the diversification tests, REITs have invested in nonvoting securities of C corporations, the voting stock of which is controlled by other persons ("Third Party Subsidiary," or "TPS"). The Internal Revenue Service granted private letter rulings approving these investments starting in 1988, although it has chosen not to rule directly on this structure since 1994⁸. Any dividends to the REIT from the TPS qualify under the REIT 95% gross income test, but not the 75% gross income test. Also, the REIT's stock in the TPS does not qualify under the 75% asset test. Accordingly, a REIT continues to be principally devoted to real estate operations.

The TPS structure is economically important because it has allowed REITs to use their assets and expertise to provide real estate related services to non-tenants in a format that is fully taxable. However, the structure is awkward because the REIT is not allowed to control the subsidiary. To satisfy the diversification tests, 90% or more of its voting stock must be owned by parties other than the REIT, and stock in each TPS cannot be worth more than 5% of the REIT's assets. The inability of a REIT to own all the stock of a TPS means that REIT shareholders cannot be assured that the TPS always will act in their best interests. Also, part of the income earned by the TPS will accrue to the voting shareholders' benefit rather than the REIT shareholders.

Administration Proposals

In its proposed budget for Fiscal Year 1999 released in February 1998, the Administration proposed changing the 10% asset test described above to prohibit a REIT from owning more than 10% of the vote **or value** of a non-REIT C corporation. In apparent deference to all the IRS rulings issued since 1988 concerning third party service subsidiaries, the Treasury Department proposed to apply this limitation only to new subsidiaries created after the "date of first committee action" and to any expansion (after such date) of business activities of existing third party subsidiaries.

For most of 1998, NAREIT conducted a dialogue with the Administration and the Congress on ways in which the Treasury Department's stated concerns could be addressed while allowing the REIT industry to meet competitive demands from the marketplace. In the proposed Fiscal Year 2000 Budget released in February 1999, the Administration again recommended changing the 10% asset test to prohibit a REIT from owning more than 10% of the vote or value of a non-REIT C corporation. However, in a significant departure, the Administration called for an exception to the new 10% asset test for taxable REIT subsidiaries.⁹ The Administration explained:

⁸ See, e.g., PLRs 199917039, 9835013, 9734011, 9440026, 9340056, 8825112.

⁹ The Administration proposed two size limits for TRSs. First, the size of all TRSs would have been limited to 15% of a REIT's assets. Second, only 5% of a REIT's assets could have been in TRSs that provided non-customary services to the

Many of the businesses performed by the REIT subsidiaries are natural outgrowths of a REIT's traditional operations, such as third-party management and development businesses. While it is inappropriate for the earnings from these non-REIT businesses to be sheltered through a REIT, it also is counter-intuitive to prevent these entities from taking advantage of their evolving experiences and expanding into areas where their expertise may be of significant value.¹⁰

RMA

Effective Date. Both the new 10% vote or value test and the rules applicable to a TRS will become effective for taxable years beginning after December 31, 2000. Accordingly, the new excise taxes and limits on a subsidiary's ability to deduct interest will not apply until 2001.

10% Vote or Value Test. The RMA will prohibit a REIT from owning (at the end of each quarter) more than 10% of the vote or value of the securities of a non-REIT C corporation.¹¹ However, there will be four important exceptions to this prohibition.

First, the 10% test will not apply to any TRS securities¹². This will allow a REIT to own sufficient voting stock so as to control taxable subsidiaries that can both provide services to its tenants as well as third parties. Not only will it allow a REIT to provide more efficient services to customers, a TRS will permit transparent reporting to shareholders because the financial statements of a TRS generally will be consolidated with its affiliated REIT. Further, adopting a TRS structure will make it easier to integrate TRS employees into the REIT's compensation plans.¹³ Note that an existing TPS will be able to convert tax-free into a TRS.¹⁴

Second, the 10% test will not apply to "straight debt" securities a REIT owns in another corporation¹⁵. This will allow a REIT to own more than 10% of an issuer's securities so long as the rate on the REIT's loan is fixed and the debt is not convertible into the issuer's stock.¹⁶ For example, a triple net lease REIT may continue to extend both mortgage and equipment financing to an unrelated restaurant franchisee even if the equipment debt is worth more than 10% of the debtor's net worth.

Third, the 10% test will not apply to mortgages from a REIT to its TRS, since such mortgages (as under prior law) are considered "real estate assets" rather than securities.¹⁷

Fourth, the 10% test will not apply to certain arrangements in place¹⁸ on July 12, 1999.¹⁹ The 10% rule **will** apply if the subsidiary engages in a "substantial" new line of business or

associated REIT's tenants. In addition, the Administration would not have permitted a TRS to deduct any interest payments on debt owed to the associated REIT. Last, a 100% excise tax would have been imposed on excess payments to ensure arm's length: (1) pricing for services provided to REIT tenants (*i.e.*, REIT tenants could not pay for services provided by the TRS through increased rents to the REIT); and (2) allocation of shared expenses between the REIT and the TRS.

¹⁰ General Explanations of the Administration's Revenue Proposals at 140 (Department of the Treasury, February 1999)

¹¹ As under prior law, stock that a REIT owns in a qualified REIT subsidiary under I.R.C. § 856(i) will be ignored for all federal income tax purposes.

¹² To be certain that a corporation does not become inadvertently subject to all the restrictions and penalties attributable to being a TRS, both the REIT and the company wanting to be a TRS will need to file a written election with the IRS. Further, the RMA adopts a "tiering" rule under which any corporation in which a TRS owns more than 35% of the vote or value of its securities is automatically considered a TRS. This rule was adopted to prevent a TRS from avoiding the 100% excise taxes merely by setting up a subsidiary.

¹³ For example, a TRS employee generally will be able to qualify under the associated REIT's incentive stock option plan. Also, the REIT generally will be able to act as the "common paymaster" for the TRS employees, thereby simplifying the TRS withholding tax requirements and procedures.

¹⁴ A grandfathered TPS will be able to treat its election into a TRS before January 1, 2004 as a reorganization under I.R.C. § 368(a)(1)(A). Many believe that any election of a TPS into a TRS is not a taxable event in any case or that the conversion could be structured as a tax-free reorganization. An "A" reorganization status could be helpful in making tax-free the conversion of TPS common stock into REIT common stock.

¹⁵ See I.R.C. § 1361(c)(5).

¹⁶ To qualify for this "straight debt exception," the issuer must be an individual, the only securities of an issuer that are held by the REIT or its TRS are non-contingent and non-convertible, **or** the issuer is a partnership of which the REIT owns at least a 20% profits interest. The last alternative condition will apply to a REIT's debt to most UPREITs and DownREITs.

¹⁷ Treas. Reg. § 1.856-3(e). Note, however, that there is no parallel exemption of mortgages from the new test under which a REIT will not be able to hold more than 20% of its assets in TRS securities.

acquires any “substantial” asset²⁰ (other than through a binding contract, a like-kind transaction, a casualty replacement or a tax-free reorganization with another grandfathered entity)²¹, or the REIT acquires any new securities in the subsidiary (other than pursuant to a binding contract in effect on July 12, 1999, or in a tax-free reorganization with another grandfathered entity).

Size of a TRS. Under the RMA, no more than 20% of a REIT’s gross assets may be securities²² of a TRS, which will be measured at fair market value. As under prior law, the value of non-traded securities that is established by a REIT’s board of directors in good faith is conclusively presumed to be correct.²³ Note that stock of a C corporation such as a TRS is not a qualified asset under the existing 75% asset test,²⁴ and that REITs typically own other assets (such as personal property) that also do not qualify under this test.

In addition, any dividends a REIT receives from a TRS will qualify for the 95% income test²⁵ but **not** the 75% income test.²⁶ This will parallel the treatment of TPS dividends under prior law. Since TRS income will be fully subject to a corporate-level income tax, the TRS will not have to distribute its after-tax earnings to its affiliated REIT. However, a TRS’ retention of after-tax earnings presumably will increase its value for purposes of the 20% and 75% asset tests.

Last, prior law restricts a REIT from owning more than 5% of its assets in the securities of a single issuer.²⁷ Under the RMA, this 5% test will not apply to a REIT’s ownership of a TRS.

Scope of a TRS’ Activities. So, what will a TRS be able to do? The short answer is any third party activity that a TPS can perform under prior law plus generally any type of service to the associated REIT’s tenants, including non-customary services. Thus, a TRS will be able to provide tennis lessons to an apartment REIT’s tenants, offer concierge services to an office REIT’s tenants, engage in land development, extend bulk purchasing discounts to tenants, and partner up with other entities to provide a range of services. All such activities will be fully subject to a corporate level tax.²⁸

The RMA prohibits a TRS from operating or managing hotels or health care facilities²⁹. Further, a TRS will not be able to be a franchiser of any brand name under which a lodging or health care facility is operated.

TRS Interest Deductions. Congress and the Administration wanted to be certain that a TRS could not avoid the corporate level tax by borrowing an inappropriate level of capital from its affiliated REIT and deducting the resulting interest deductions.

Congress confronted very similar “earnings stripping” concerns in the 1980s with respect to foreign organizations and their U.S. subsidiaries and resolved these concerns by enacting Code

¹⁸ The 10% test will not apply to securities: (1) held by a REIT on July 12, 1999; (2) held by an entity on that date if a REIT later acquires control of such entity pursuant to a binding contract on such date; (3) that a REIT receives in a tax-free transaction in exchange for securities described in (1); and (4) that are described in (1)-(3) that a REIT later receives in a tax-free reorganization from another REIT.

¹⁹ July 12, 1999, is the date the RMA was included in the “Chairman’s Mark” for consideration of the House Ways and Means Committee.

²⁰ Perhaps as an incentive to encourage owners of a TPS to have it convert into a TRS, the legislative history does not provide any guidance as to how “substantial” should be defined.

²¹ See I.R.C. § 1031 and 1033.

²² See footnote 17.

²³ I.R.C. § 856(c)(5)(A); Treas. Reg § 1.856-3(a). Accordingly, it is useful for a REIT’s board of directors to review and approve the values calculated by the REIT’s management every quarter in which there is any uncertainty as to the ratios under all the REIT asset tests.

²⁴ I.R.C. § 856(c)(4)(A).

²⁵ I.R.C. § 856(c)(2).

²⁶ I.R.C. § 856(c)(3).

²⁷ I.R.C. § 856(c)(4)(B). This rule does not prevent a REIT from owning stock of multiple TPSs so long as the stock of each represents 5% or less of the REIT’s assets.

²⁸ Section 547 of Pub. L. No. 106-170 requires the Treasury Department to issue a study on the number of companies that elect TRS status and the aggregate amount of taxes paid by them. No deadline was set for this study.

²⁹ For this purpose, a health care facility will include a hospital, nursing facility, assisted living facility, congregate care facility, or other licensed facility that extends medical care to patients and is operated by a provider eligible for Medicare reimbursement.

section 163(j).³⁰ This section permits interest deductions on objective, modest amounts of related party debt.³¹ Further, the RMA will impose a 100% excise tax on any interest payments from a TRS to its affiliated REIT to the extent the interest rate is set at above a commercial reasonable level. As with any other C corporation, a TRS will be able to deduct interest payments to unrelated parties without restriction.

Rents from the TRS to Its Associated REIT. Prior law classifies as non-qualified income any amounts a REIT receives as rental payments from a “related party,” *i.e.*, an entity that is 10% or more owned by the REIT³². There may be substantial business reasons why a TRS would need to rent some space from its affiliated REIT. Further, rents between a TRS and its REIT can be easily measured by comparable rents to unrelated parties.

The RMA will allow payments from a TRS for space rented from a REIT to be considered qualified rents under the REIT income tests if (1) the TRS rents no more than 10% of the leased space of a property; and (2) the TRS pays substantially the same rents for similar space as the non-related parties at the same property.

- *Lodging Facilities.* Under prior law, a REIT that owns a hotel is required to lease the hotel property to an unrelated third party. However, many large operators of hotels strongly prefer operating these properties pursuant to management contracts, rather than leases. Accordingly, under prior law a REIT that owns a hotel that is operated by one of these unrelated operators must lease the property to a third-party lessee that in turn contracts with the operator to manage the property. The interjection of the third-party lessee into the traditional owner-operator relationship creates numerous complexities, additional potential conflicts of interest and economic inefficiencies, without serving any particular tax policy objective when the operator is not affiliated with the REIT.

The RMA creates another exception to the related party rule under which payments a REIT receives from its TRS from the lease of a lodging facility³³ will be considered as qualifying rental income under the REIT rules. To qualify for this exception, (a) the rents must be set at a market levels; (b) the rents may not be tied to net profits; (c) the lodging facility³⁴ must be operated by an independent contractor that actively operates such facilities for unrelated third parties; and (d) no organized gambling occurs at the facility.

Arm’s Length Pricing.

- *Services to REIT Tenants.* When a TRS provides a service to a REIT’s tenant, the concern may arise that (to avoid a corporate level of tax) a REIT could inflate the rents charged to the tenant and have the TRS charge less than an arm’s-length rate for the service. The transfer pricing rules of Code Section 482 would allow the Internal Revenue Service to allocate the appropriate income and expenses between related corporations and to assess interest and penalties (including the newly-strengthened substantial understatement penalty) against the corporations for not using arm’s length pricing.

The RMA adopts a more rigorous sanctions regime to avoid the possibility of a REIT using a TRS to, in effect, convert taxable service income into REIT rents that would avoid a corporate level of tax. Under the RMA, a REIT will pay a 100% excise tax on any rents from

³⁰ Note, however, that the RMA will not disallow a TRS’ interest deductions on debt to third party lenders that is guaranteed by its affiliated REIT, as such guarantees reduce a TRS’ interest rate and thereby increase its taxable income.

³¹ Under this test, a TRS will be able to deduct interest payments to its affiliated REIT only if (1) the ratio of its debt to its equity (defined as the aggregate tax basis of its assets reduced by such debt) is less than 1.5 to 1; or (2) half of its net income (before deducting interest, net operating losses and depreciation) is greater than its net interest expense.

³² I.R.C. § 856(d)(2)(B). Before the RMA, a corporation was considered a related party to a REIT if the REIT owned stock representing 10% or more of the corporation’s voting power or more than 10% of the outstanding number of shares. To conform this test to the new 10% asset rule, the RMA will change the related party test to 10% of the vote or value of a corporation’s stock. As with the rest of the RMA, the change to the related party rule will apply to taxable years beginning after 2000.

³³ A lodging facility is defined as a hotel, motel, or other establishment more than one-half of the dwelling units in which are used on a transient basis. *Cf.* Treas. Reg. § 1.48-1(h)(2)(ii), which states that accommodations are considered used on a transient basis if the rental period normally is less than 30 days.

³⁴ A lodging facility includes amenities and facilities customarily operated as part of such facility of comparable size and class. For example, catering facilities at a full service hotel certainly will be considered amenities that a TRS could lease to its affiliated REIT. However, a skiing resort dwarfing a hotel on the slopes might not be considered such an amenity.

tenants receiving services from the TRS to the extent they are above the amount that would be charged to tenants not receiving this service. Because this penalty is so severe (going beyond the profit level imbedded in providing the service), this 100% excise tax will be imposed in place of reallocation under the transfer pricing rules of Code section 482.³⁵

The RMA contains some safe harbors that a REIT could use to objectively satisfy arms' length requirements necessary to avoid the 100% excise tax penalties. The excise tax will not apply if a TRS provides a substantial amount of services to third parties at the same prices offered to tenants of its affiliated REIT. Second, the 100% excise tax will not apply when rents for comparable leased space at the same property are the same regardless of whether the tenants are provided services (which would be separately stated). To qualify for this safe harbor, at least 25% of the REIT's tenants at any particular property can not use such services supplied by the TRS.³⁶ Third, the 100% excise tax will not apply when income from the TRS providing a service to REIT tenants is at least 150% of the direct costs of providing the services.³⁷ This pricing formula will provide a convenient, easy to administer standard to judge whether the TRS is charging tenants an adequate fee for its services.

Considering the confiscatory nature of the excise tax, these safe harbors are needed to ensure that REITs will not be penalized for legitimate business transactions.

- *Cost Allocation.* The transfer pricing rules of Code section 482 allow the IRS to reallocate costs between related parties, including a corporation and its subsidiary. Any deductible expenses allocated away from a C corporation increase its tax liabilities, including interest charges. Further, the 20% and 40% penalties for substantial or gross valuation misstatements can apply.

Since under the RMA a REIT will be able to own up to 100% of a TRS, Congress wanted to forestall a REIT's allocating part of its overhead costs to the TRS to reduce the subsidiary's tax liabilities.³⁸ To curtail such misallocation, the RMA will impose a 100% excise tax on any amount by which a REIT understates its deductions and overstates those of its TRS by misallocating expenses between them.³⁹ A REIT will be presumed to meet its burden of proof of properly allocating costs between it and its TRS under tests to be developed by the Treasury Department.⁴⁰ Until the Secretary issues such guidance, a REIT and its TRS will be able to rely on any reasonable allocation method.

DISTRIBUTION REQUIREMENT

Background

In developing the original REIT structure in 1960, Congress looked substantially to the rules then governing regulated investment companies, otherwise known as mutual funds. Accordingly, REITs and mutual funds face similar qualification requirements. Among those requirements are limitations on the type of income each entity may generate and a mandated distribution of taxable income (with the exception of capital gains). At their inception in 1960, REITs and mutual funds both were subject to a 90% ordinary income distribution test.

In 1976, Congress passed several amendments to the REIT rules. One change was to provide a "deficiency dividend procedure" ("DDP") that protected a REIT under the required

³⁵ For purposes of this article, all references to "Code" are to the Internal Revenue Code of 1986, as amended.

³⁶ Under this safe harbor, the IRS readily could compare the rents of tenants receiving the service with the rents of tenants not receiving the service. If equivalent tenants pay similar rents for equivalent space regardless of whether they receive a service from the TRS, then it would be clear that the service must be priced on an arm's length basis.

³⁷ The 150% "gross-up" rule is based on the one used in the 1% *de minimus* test Congress enacted in 1997. See I.R.C. § 856(d)(7)(D).

³⁸ It is entirely appropriate for part of an employee's salary to be charged to a TRS to the extent that the employee renders services on behalf of the subsidiary. For example, an employee who landscapes both the REIT's apartment complexes and properties owned by a third party should be compensated both by the REIT and by the subsidiary that provides the landscaping services to the third party. However, it is inappropriate for the subsidiary to be charged for the employee's expenses for his or her time spent on the REIT properties.

³⁹ Again, this confiscatory 100% tax will be in lieu of the I.R.C. § 482 regime.

⁴⁰ Any Treasury Regulations could consider maintaining adequate market survey data or record keeping as satisfying this burden of proof.

distribution test when the REIT's taxable income for a prior year was redetermined pursuant to an IRS audit in a subsequent year. Accompanying the introduction of the DDP was an increase in the required distribution of taxable ordinary REIT income to 95% (effective on January 1, 1980).

In 1978, the DDP concept was extended to mutual funds. However, Congress did not seek to impose the higher income distribution requirement to mutual funds that accompanied the DDP when introduced for REITs in 1976, nor did it address why the REIT distribution requirement should stay at 95%.

The original 90% taxable income distribution requirement reflected the intent of Congress to mirror the REIT rules after the mutual fund rules and an understanding that such entities could have legitimate business reasons for choosing to pay a corporate level tax in order to retain a small portion of their income. This flexibility is especially important in the capital-intensive commercial real estate leasing business under which REITs must incur capital expenditures to maintain the quality of their properties. In addition, a 90% distribution requirement can provide a valuable source of after-tax revenues to make principal payments on outstanding debt.

This proposal was included as part of H.R. 1150, the Real Estate Investment Trust Simplification Act of 1997, but was not included for procedural reasons in the REIT-related provisions Congress adopted as part of the Taxpayer Relief Act of 1997.

RMA

The RMA will return the 95% annual distribution requirement to the original 90% threshold, effective for taxable years beginning after 2000. A REIT will continue to be required to pay a corporate level tax to the extent its taxable earnings exceed its dividends paid deduction, but it can then retain and use the after-tax proceeds for any purpose.

PERSONAL PROPERTY RENTS

Background

Under the 1960 legislation authorizing REITs, rents a REIT received attributable to personal property leased with real property (e.g., a refrigerator and drapes in an apartment) were disqualified under the REIT tax tests. In 1976, Congress recognized that certain types of real property leased by REITs contain an incidental amount of personal property. Therefore, Congress permitted REITs to treat rents from personal property as qualifying income, provided that these personal property rents did not exceed 15% of the total rents from the particular property.

Prior law calculates personal property rents by comparing the adjusted tax basis of the personal property with the adjusted tax basis of both the personal and real property.⁴¹ Although this rule worked well at a property's initial acquisition, over time it became unworkable.

When a REIT purchases a building and its incidental personal property at the same time, the ratio of the personal property's adjusted tax basis to the total property's tax basis is equal to the ratio of the personal property's fair market value to the total property's fair market value. When a REIT that has held a building for many years (or that acquires the building in a carryover basis transaction) buys new personal property, the adjusted basis of the personal property will be equal to the fair market value of the personal property, but the adjusted basis of the real property may be significantly less than its fair market value.⁴² Thus, for older buildings with new personal property the REIT might not satisfy prior law's *de minimis* test even though the value of the personal property may be significantly less than 15% of the total property's value. If so, the

⁴¹ As an example, if a REIT purchased an apartment building for \$1 million and, at the same time, upgraded the building with dishwashers, refrigerators, stoves, and garbage disposals for which it paid \$100,000, all of the rental income earned by the REIT from the apartment building and the incidental personal property would be qualifying income because the adjusted basis of the personal property (\$100,000) would be less than 15% of the combined adjusted basis of the real and personal property (\$1,100,000).

⁴² This mismatch is particularly glaring when the REIT or its predecessor depreciated the building under the much shorter useful lives that applied during the 1970s and 1980s.

REIT would have to treat a portion of the property's rents as non-qualifying income, filling up its 5% "bad" income basket, and risking REIT disqualification.⁴³

RMA

Effective for taxable years beginning after 2000, the RMA will base the 15% personal property test on fair market values instead of adjusted tax basis.

HEALTH CARE REITS

Background

A REIT is permitted to conduct a trade or business using property acquired through foreclosure for 90 days after it acquires such property, provided the REIT makes a foreclosure property election. After the 90-day period, the REIT may no longer conduct such trade or business, except through an independent contractor from whom the REIT does not derive or receive any income. Property is eligible for a foreclosure election if the REIT acquired it through foreclosure on a loan or default on a lease, but not if the REIT acquired it because a lease expired. If it makes the foreclosure property election, a REIT may hold foreclosure property for resale to customers without being subject to the 100% penalty tax on the gain under the prohibited transaction rules. Non-qualifying income from foreclosure property generally is subject to the highest corporate tax rate (now 35%).

Under the Code, foreclosure property status is lost if, at some time after 90 days from the date such property is acquired, the property is used in a trade or business conducted by the REIT (other than through an independent contractor from whom the REIT does not derive any income).

Health care REITs face unique problems under the foreclosure property rules when the lessee/operator of a health care facility terminates its lease, either through expiration or default. Unlike most other forms of rental properties, if a health care property lease terminates, it is extremely difficult to close the facility because medical services to patients must be maintained. A variety of government regulations mandate measures to protect patients' welfare, which greatly restrict the ability simply to close the facility. In addition, because of the limited number of qualified health care providers, it can be difficult to find a substitute provider that also will lease the property.

Therefore, in order to keep a health care facility operational after the 90-day period has expired under the foreclosure property rules, a REIT must be able to hire a licensed health care provider that also qualifies as an independent contractor from whom the REIT does not derive or receive any income or profits. The limited pool of licensed providers that could qualify as independent contractors may be dramatically reduced, since many of these providers already lease other health care properties owned by the REIT. Thus, the IRS may view these existing lessees of the REIT as disqualified from serving as independent contractors.

A provision to address this problem was included as part of H.R. 1150, the Real Estate Investment Trust Simplification Act of 1997, but was not included for procedural reasons in the REIT-related provisions Congress adopted as part of the Taxpayer Relief Act of 1997.

RMA

The RMA provides that, in the case of qualified health care properties, a health care provider will not be disqualified as an independent contractor for purposes of the foreclosure

⁴³ Using the example in footnote 38, assume the apartment building is still worth \$1 million, but it has a tax basis of \$100,000, and the REIT refurbishes each apartment in the apartment building with new dishwashers, refrigerators, stoves, and garbage disposals for which it pays \$130,000. Under current law, although the personal property may still be *de minimis* based on value, the adjusted basis test described above results in the adjusted basis of the personal property (\$130,000) being almost 57% of the adjusted basis of the total property (\$230,000). Thus, the rental income attributable to the incidental personal property would not qualify under the REIT tax tests.

property rules solely because a REIT receives rental income from the provider with respect to one or more other properties. In addition, a REIT will be able to make a foreclosure property election with respect to lease expirations of a qualified health care property.⁴⁴ The RMA will not extend the 90-day grace period in which the REIT could directly operate the property after the foreclosure event. The effective date of the health care REIT change will be taxable years beginning after 2000.

The RMA will help ensure that important health care facilities are not forced to close because of a technical requirement in the Code.⁴⁵

INDEPENDENT CONTRACTOR DEFINITION

Background

When Congress first enacted REIT legislation in 1960, virtually all operations had to be carried out by independent contractors from which the REIT could not receive any income. An independent contractor is defined as an entity that does not own (directly or indirectly) more than 35% of a REIT's stock or an entity not more than 35% owned (directly or indirectly) by persons who own more than 35% of the REIT's stock. In 1986, Congress allowed REIT employees to directly provide customary services to REIT tenants. However, REITs must use independent contractors to provide to their tenants more than a de minimis amount of non-customary services. Further, under the RMA a TRS must operate any lodging facility through an independent contractor.

It is difficult, if not impossible, to determine if a publicly traded corporation meets these tests because public stock is fungible, and the SEC only requires persons owning more than 5% of a SEC-registered company to disclose their ownership.

RMA

When testing a corporation as an independent contractor of a REIT, if either entity is publicly traded the RMA will examine only shareholders owning more than 5% of the each entity's stock.⁴⁶ The effective date will be taxable years beginning after 2000.

EARNINGS & PROFITS

Background

When a non-REIT C corporation elects REIT status or merges into a REIT, the Code requires that all pre-REIT earnings and profits ("E&P") must be distributed to its shareholders by the close of the REIT's first taxable year. The Real Estate Investment Trust Simplification Act of 1997 made an ordering change intended to prevent a company from losing its REIT status merely because it underestimated its pre-REIT E&P.⁴⁷

RMA

The RMA will make additional technical ordering rule changes and will allow a REIT to use the deficiency dividend procedure when a company's pre-REIT E&P increases as a result of an IRS audit of its pre-REIT tax years. These changes also will take effect for taxable years beginning after 2000.

ESTIMATED TAXES FOR CLOSELY HELD REITS

Background

It recently came to the attention of Congress that several publicly traded C corporations had used a REIT to defer estimated tax payments. Under this planning strategy, the C

⁴⁴ See footnote 28 for the definition of a health care facility.

⁴⁵ See 145 Cong. Rec. S5381 (Daily Ed. May 14, 1999) (Remarks of Sen. Bob Graham).

⁴⁶ The rule will parallel the test contained in I.R.C. § 382(g)(4).

⁴⁷ I.R.C. § 857(d)(3).

corporation would own virtually all of the economics and voting control of a REIT, while 100 other shareholders owned the rest of the REIT's stock.⁴⁸ For purposes of paying its quarterly estimated taxes, the principal owner did not take the income generated by the REIT into account until the REIT distributed its dividends.

RMA

The RMA prescribes special estimated tax rules for a closely held REIT, which is defined as a REIT of which five or fewer persons⁴⁹ (without applying any look-through rules) own 50% or more (by vote or value) of the REIT's stock. Any person owning 10% or more of a closely held REIT will have to annualize the REIT's expected dividends when it computes its quarterly estimated tax payments.⁵⁰ This provision is effective for estimated tax payments due on or after December 15, 1999.

⁴⁸ Since the C corporation was publicly traded, there was no violation of the "five or fewer" test of I.R.C. § 856(h)

⁴⁹ Under I.R.C. § 7701(a)(1), a person includes an individual, a trust, estate, partnership, association, company or corporation.

⁵⁰ The other closely held provision that had been included in the vetoed Taxpayer Refund and Relief Act of 1999 (which would have prevented most persons from owning 50% or more of the vote or value of a REIT's stock) was **not** included in bill enacted into law in December, 1999.