

National Policy Bulletin

REIT MODERNIZATION ACT BECOMES LAW

December 17, 1999

Introduction

On December 17, the President signed into law H.R. 1180, the Work Incentives Improvement Act of 1999. H.R. 1180 contains the REIT Modernization Act provisions NAREIT has strongly supported this year, including changes that, effective in 2001, will allow REITs to own a taxable REIT subsidiary ("TRS"). To review the statutory language and legislative history for the REIT provisions in H.R. 1180, see the Government Relations section of www.nareit.com.

NAREIT applauds the Congress and the Administration for passing these important REIT modernization provisions. We extend special thanks to the REIT Modernization Act's principal sponsors: Rep. Bill Thomas (R-CA), Rep. Ben Cardin (D-MD), Sen. Connie Mack (R-FL), and Sen. Bob Graham (D-FL).

Summary of REIT provisions

Taxable REIT Subsidiaries. Effective in 2001, H.R. 1180 will allow a REIT to own up to 100% of the stock of a TRS that can provide services to REIT tenants and others without disqualifying the rents that a REIT receives from its tenants. The bill contains size limits on TRSs to ensure that a REIT remains focused on core real estate ownership and operations. Specifically, TRS securities may not exceed 20% of a REIT's assets, and the dividends from a TRS will not qualify as "good income" under the REIT's 75% income test.

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, 100% excise taxes will be imposed to the extent the transactions between a TRS and its affiliated REIT or that REIT's tenants are not conducted on an arms' length basis. A TRS may not operate or manage lodging or health care facilities, but it may lease lodging facilities from its affiliated REIT at market rates so long as an independent contractor operates and manages the lodging facilities. With the exception of a TRS, 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 certain debt securities), again effective in 2001.

The bill's restrictions on TRSs will not apply to arrangements in place (including third party subsidiaries) as of July 12, 1999, so long as the third party subsidiary does not engage in a new line of business, its existing business does not increase, and the REIT does not acquire any new securities in the subsidiary. Under the bill, a third party subsidiary will be able to convert tax-free into a TRS.

Distribution Requirement. Effective in 2001, H.R. 1180 will return the distribution requirement from 95% to the 90% level that applied to REITs from 1960 to 1980.

Personal Property Rule. Effective in 2001, H.R. 1180 will change the measurement of the REIT 15% personal property rule from adjusted tax basis to fair market value.



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Health Care REITs. Effective in 2001, H.R. 1180 will allow a REIT to hire an independent contractor to operate nursing homes and other health care facilities 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. Effective in 2001, in the case of a publicly traded corporation being tested as an independent contractor, H.R. 1180 only will examine shareholders owning more than 5% of the corporation's stock.

Earnings & Profits Rules. To prevent some traps for the unwary, H.R. 1180 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.

Estimated Taxes for Closely Held REITs. Effective December 15, 1999, H.R. 1180 will

require a 10%-or-more shareholder of a closely held REIT (defined as when five or fewer persons own 50% or more of the vote or value of a REIT's stock) to annualize the dividends from such REIT for purposes of computing the shareholder's estimated tax payments. Note that the other closely held REIT provision that was in the vetoed tax bill (which would have prevented most persons from owning 50% or more of the vote or value of a REIT's stock) is **not** in H.R. 1180.

Other Real Estate Related Provisions

Installment Method. Effective for installment sales on or after the final date of enactment, H.R. 1180 will prohibit accrual basis taxpayers (like virtually all REITs) from using the installment method of accounting to defer income from the sale of property.

Brownfields Environmental Remediation. H.R. 1180 will extend through December 31, 2001 the ability under prior law to expense environmental remediation expenditures incurred in connection with the abatement or control of hazardous substances at certain contaminated sites.

Please visit the Government Relations area of www.nareit.com or contact Tony Edwards (tedwards@nareit.com) or Dara Freedman (dfreedman@nareit.com) for more information.