

National Policy Bulletin



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CONGRESSIONAL LEADERS REACH STIMULUS BILL COMPROMISE: INCOME TAXES ON DEBT BUYBACKS AND LOAN MODIFICATIONS TO BE DEFERRED FOR FIVE YEARS

Agreement Reached

Last evening, Congressional leaders announced they had reached a compromise relating to H.R. 1, the “America’s Recovery and Reinvestment Tax Act of 2009,” a \$789 billion economic stimulus package. The final legislative language of the agreement is not yet officially available, but the outlines of the deal are known.

The final bill contains a number of provisions relevant to the REIT and real estate investment community.

Income Taxes on Debt Buybacks, Loan Modifications and Cancellations to be Deferred for Five Years

Most significantly, the final bill includes a provision which permits the deferral of taxes tied to income stemming from the discharge or cancellation of indebtedness coming about through debt buybacks at a discount or loan modifications. For transactions occurring in 2009, the complete deferral extends for five years; and for transactions occurring in 2010, the complete deferral extends for four years. Thereafter, the deferred income will be taxed in installments of 20 percent per year over the next five years. [CLICK HERE](#) for a letter from a coalition including NAREIT that expressed support for broad relief from the cancellation of indebtedness tax rules.



The bill applies to cash repurchases as well as to “re-acquisitions” of debt in 2009 or 2010 whether in exchange for new debt (including deemed modifications due to modifications of the existing debt) or in exchange for stock or partnership interests. A reacquisition of debt also includes contributions of the outstanding debt to capital, as well as complete forgiveness of the outstanding debt.

The provision generally applies to C corporations and taxpayers that are engaged in a “trade or business.” Since REITs are deemed C corporations, this provision would apply to debt repurchased or “reacquired” by a REIT. This treatment is in contrast to current law under which a REIT may not exclude or defer cancellation of debt income unless it is insolvent or in bankruptcy. This provision similarly will apply to cancellation of debt income realized by the partnerships and limited liability companies (LLCs) in which REITs invest so long as the income arises from debt issued by these entities in the conduct of a trade or business.

A 2001 IRS revenue ruling held that a REIT could be engaged in the active conduct of a

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trade or business because a REIT “is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property.” In the case of non-C corporations, since the new provision merely requires that the debt must have been issued in connection with the conduct of a “trade or business” (rather than an active trade or business), it seems clear that a pass-through entity in which a REIT owns an interest (such as an Operating Partnership in an UPREIT structure) should be viewed as engaged in a “trade or business.”

To the extent the qualifying income under the provision is recognized by a partnership or other pass-through entity, the election to defer the income must be made by the pass-through entity. Thus, the deferral of the income would apply across the board to all of the pass-through entity’s owners. The bill provides the IRS with regulatory authority to implement these provisions. There still may be residual issues relating to the provision’s application to multi-tier partnership structures.

Net Operating Loss Provision Scaled Back

The final bill significantly scaled back another provision which would have benefited a range of businesses, including REITs, with respect to net operating losses. Rather than permitting all taxpayers (such as taxable REIT subsidiaries) to carry back net operating losses (NOLs) for five years (instead of the two years permitted under current law), the final bill permits only a three to five year carryback period for NOLs incurred in taxable year ending in 2008. Importantly, the provision only applies now to small businesses with gross receipts of up to \$15 million per year, thereby rendering it meaningless for most REITs and their taxable subsidiaries.

Other Provisions

The final bill includes a number of other important tax provisions. For instance, negotiators retained a one-year extension of the ongoing patch to limit the effect of the alternative minimum tax on middle-income taxpayers. In addition, the final bill includes a provision extending the time period for claiming bonus depreciation applicable to qualified, second-generation tenant improvements through 2010.

Outlook

Congress will very likely approve the final bill in the coming days and President Obama anticipates signing the legislation early next week.

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