Rep Shaws Introductory Remarks on REITSA

REAL ESTATE INVESTMENT TRUST SIMPLIFICATION ACT OF 1997 ("REITSA")

Rep. Shaw's Introductory Remarks on REITSA
Excerpted from 143 Cong. Rec. E559 (Daily ed. March 21, 1997)

MR. SHAW: Mr. Speaker, today I am introducing H.R. 1150, the Real Estate Investment Trust Simplification Act of 1997 ("REITSA"), a bill to amend portions of the Internal Revenue Code dealing with real estate investment trusts, or REITs. The legislation responds to the need for simplification in the regulation of the day-to-day operation of REITs. REITSA is co-sponsored by Mr. Matsui, Mr. Crane, Mr. Thomas, Mrs. Johnson, Mr. Houghton, Mr. Herger, Mr. McCrery, Mr. Camp, Mr. Johnson, Ms. Dunn, Mr. Collins, Mr. English, Mr. Ensign, Mr. Weller, Mr. Stark, Mr. Levin and Mr. Cardin. The Joint Committee on Taxation has determined that REITSA has a negligible effect on Federal fiscal year budget receipts. In 1960, Congress created REITs to function as the real estate equivalent of the regulated investment company, or mutual fund. As such, they permit small investors to participate in real estate projects that the investors could not undertake individually and with the assistance of experienced management. Over time, the REIT industry has matured into its intended role with the greatest strides made in this decade. This development of the REIT industry is a result of a number of factors. As important as any other were the changes Congress enacted in 1986 to the REIT rules themselves and the tax landscape in general. With respect to the general provisions, throughout the 1980s limited partnerships used the offer of multiple dollars of tax paper losses for each invested dollar to attract investors away from solid investments like REITs, which seek to provide investors with consistent distributions from economically feasible real estate investments but provide no opportunity to receive a pass-through of tax motivated losses. Accordingly, the elimination of those tax loss loopholes led investors to look for income-producing investment opportunities. Also included in the 1986 tax legislation were important modifications to the REIT provisions of the Code. Among the changes made as part of that modernization of the REIT tax laws (the first in a decade and the most recent comprehensive revision of the REIT laws), the most significant was the change allowing REITs to directly provide to tenants those services customary in the leasing of real estate as had been permitted to pension plans and other tax-exempt entities engaged in the leasing of real property. Prior to that change, a REIT was required to use an independent contractor to provide those services. These legislative changes and the lack of credit to recapitalize America's real estate produced a suitable environment for the substantial growth in the REIT industry and the fulfillment of Congress' original hopes for the REIT vehicle. From 1990 to present, the industry has grown from a market capitalization of approximately $9 billion to nearly $100 billion. Fueling that growth has been the introduction of some of America's leading real estate companies to the family of long existing, viable REITs. As a result, the majority of today's REITs are owners of quality, income-producing real estate. Thus, hundreds of thousands of individuals that own REIT shares through direct investment (plus the many more who are interest holders in the growing number of mutual funds or pension funds investing in REITs) have become participants in the recapitalization of tens of billions of dollars of America's best real estate investments. Likewise, investors in mortgage REITs have the opportunity to participate in the ever growing market for securitized mortgages, further contributing to the recapitalization of quality real estate. The benefits of the growth in the REIT industry were addressed in a 1995 Urban Land Institute White Paper titled The REIT Renaissance. That White Paper concluded that "[f]rom an overall economic standpoint, the real estate industry and the economy should be well served by the expansion of the REIT industry-- the broadening of participation in real estate ownership, the investment in market information and research that the public market will bring, and the more timely responsiveness to market signals that will result from better information and market analysis."

To assist the continued growth of this important industry, H.R. 1150 was developed to address areas in the existing tax regime that present significant, yet unnecessary, barriers to the use of the REIT vehicle. The proposals represent a modernization of the most complex parts of the regulatory structure under which REITs operate, while leaving intact the basic underlying ownership, income, asset, and distribution tests introduced in the original REIT legislation. The proposals are supported by the National Association of Real Estate Investment Trusts, the National Realty Committee, the International Council of Shopping Centers, the National Multi-Housing Council, the Building Owners and Managers Association International, the National Association of Industrial & Office Properties and other national organizations.

SUMMARY OF KEY PROVISIONS OF H.R. 1150
A. Title I contains three proposals to remove unnecessary "traps for the unwary." These proposals would address current requirements that are not necessary to satisfy Congressional objectives, that carry a disproportionate penalty for even unintentional oversights, or that are impracticable in today's environment. Title I's overriding intention is not to penalize a REIT's many small investors by stripping the REIT of its tax status as a result of an act that does not violate Congress' underlying intent in creating the REIT vehicle.

Section 101. Shareholder Demand Letter.

The potential disqualification for a REIT's failure to send shareholder demand letters should be replaced with a reporting penalty. Under present law, regulations require that a REIT send letters to certain shareholders within 30 days of the close of the REIT's taxable year. The letters demand from its shareholders of record, a written statement identifying the "actual owner" of the stock. A REIT's failure to comply with the notification requirement may result in a loss of REIT status. The failure to send so-called demand letters may result in the disqualification of a REIT with thousands of shareholders that easily satisfies the substantive test because of a purely technical violation. As a result of disqualification, a REIT would be compelled to pay taxes for all open years, thereby depriving their shareholders of income generated in compliance with all of the REIT rules. Fortunately, the Internal Revenue Service has not enforced any such technical disqualifications and instead has entered into closing agreements with several REITs. The proposal would alleviate the need to enter into such closing agreements on a prospective basis.

H.R. 1150 provides that a REIT's failure to comply with the demand letter regulations would not, by itself, disqualify a REIT if it otherwise establishes that it satisfies the substantive "five or fewer" ownership rules. But under these circumstances, a $25,000 penalty ($50,000 for intentional violations) would be imposed for any year in which the REIT did not comply with the shareholder demand regulations and the REIT would be required, when requested by the IRS, to send curative demand letters or face an additional penalty equal to the amounts related above. In addition, to protect a REIT that meets the regulations, but is otherwise unable to discover the actual ownership of its shares, the bill provides that a REIT would be deemed to satisfy the "five or fewer" share ownership rules if it complies with the demand letter regulations and does not know, or have reason to know, of an actual violation of the ownership rules.

Section 102. De Minimus Rule for Tenant Services Income.

The uncertainty related to qualifying services for a REIT should be addressed by a reasonable de minimus test. In 1986, Congress modernized the REITs' independent contractor rules to allow them to directly furnish to tenants those services customary in the management of rental property. However, certain problems persist. Under existing law, a REIT's receipt of any amount of revenue as a result of providing an impermissible service to tenants with respect to a property may disqualify all rents received with respect to that property. For example, if a REIT's employee assists a tenant in moving in or out of an apartment complex (a potentially impermissible service), technically the IRS could contend that all the income from the apartment complex is disqualified, even though the REIT received no direct revenue for the provided service. The disqualification of a large property's rent could seriously threaten, or even terminate, the REIT's qualified status. Interestingly, at the same time a REIT could be severely punished for providing services to tenants or their visitors, the REIT rules properly provide that up to 5% of a REIT's gross income may come from providing services to non-tenants. Thus, under present law a REIT is better off providing services to nontenants than providing the same services to tenants. In addition to the potential disqualification of rents, the absence of a de minimus rule requires the REIT to spend significant time and energy in monitoring every action of its employees, and significant dollars in attorney fees to determine whether each potential action is an impermissible service. The uncertainty regarding the permissibility of services also requires the IRS to expend considerable resources in responding to private ruling requests. To lessen the burden of monitoring each REIT employee's every action and to eliminate unnecessary disqualification of tenant rents, H.R. 1150 provides for a de minimus exception. The exception would treat small amounts of revenue resulting from an impermissible service in a manner similar to revenue received from providing services to non-tenants, and protect the classification of rents from the affected property as qualifying REIT income. The de minimus exception is equal to 1% of the gross income from the affected property. The de minimus exception is based on gross income to be consistent with the REIT's income tests, and is set at 1% to reflect an amount large enough to provide the requisite safe harbor (note that it is 1% of the income from an affected property, regardless how small, and not all properties owned by the REIT), yet small enough not to encourage disregard of the independent contractor rule. Because many of the services in question would not result in a direct receipt of gross income, the bill provides a mechanism for establishing the gross income received relative to an impermissible service. The gross income would be deemed at least equal to the direct costs of the service (i.e. labor, cost of goods) multiplied by 150%. For example, if the IRS determined that a REIT's providing wheelchairs at a mall is an impermissible service, the cost of the wheelchairs would be multiplied by 150% to achieve the gross income realized from the impermissible service. If that and any other gross income related to impermissible services provided to tenants of that mall does not exceed 1% of the malls gross income for the year, the impermissible service income would be classified as non-qualifying income. However, rents received from tenants of the mall would not be disqualified.

A REIT's actions are still policed under this change. First, if a REIT's gross income from impermissible services exceeds 1% of the gross income from the affected property, that income and the rents from that property would be disqualified as under current law. Second, as previously noted, a REIT's gross income from non-qualifying sources is limited to 5% of total gross income. Accordingly, gross income from impermissible sources that does not exceed the 1% threshold would be included in that small basket, thereby placing a second check on the REIT's activities.

Section 103. Attribution Rules Applicable To Tenant Ownership.

Unintended double attribution under section 318 should be minimized, while preserving the intended purpose of the attribution rule. The attribution rules of section 318 are interjected to ensure that a REIT does not receive rents from a 10% or more related party, in which case the rents are deemed disqualified income for the REIT gross income tests. While the intention of that rule is proper, a quirk in the application of section 318 to REITs as called for under section 856(d)(2) may result in the disqualification of a REIT's rents when no actual direct or indirect relationship exists between the REIT and tenant. Under section 318(a)(3)(A), stock owned directly or indirectly, by a partner is considered owned by the partnership. In addition, under section 318(a)(3)(C), a corporation is considered as owning stock that is owned, directly or indirectly, by or for a person who also owns more than 10% (in the case of REITs) of the stock in such corporation. Those attribution rules may create an unintended result when several persons who collectively own 10% of a REIT's tenant, also own collectively 10% of the REIT. So long as those persons are unrelated, because their individual interests in both the REIT and tenant do not equal 10% the REIT is not deemed to own 10% of the tenant. However, if those persons obtain interests, regardless of how small, in the same partnership the REIT will be deemed to own 10% of the tenant. This results from the partnership's deemed ownership of the partners' stock in both tenant and the REIT. Further, because the partnership becomes a deemed 10% owner of the REIT under section 318(a)(3)(A), REIT is deemed the 10% owner of tenant under section 318(a)(3)(C). In essence, the REIT becomes the deemed 10% owner of its tenant as a result of a variation of the partner-to-partner attribution that section 318(a)(5)(C) specifically was enacted to prevent. It is only through the combination of the partners' various interests in the REIT and tenant that a disqualification of the rents occurs. This is true regardless of the purpose for the partnership's existence. The partners may have no knowledge of the other's existence and may be partners in a huge limited partnership completely unrelated to the REIT. H.R. 1150 addresses this problem by modifying the application of section 318(a)(3)(A) (attribution to the partnership) only for purposes of section 856(d)(2), so that attribution would occur only when a partner holds a 25% or greater interest in the partnership. This threshold presumes that such a partner would have knowledge of the other persons holding interests in the partnership, and would have an opportunity to determine if those persons hold an interest in the REIT. By not suspending the double attribution entirely, the bill prevents the potentially abusive practice of placing a "dummy" partnership between the REIT and those persons holding interests in the tenant.

B. Title II of REITSA contains two proposals that would assist in carrying out Congress' original intent to create a real estate vehicle analogous to regulated investment companies ("RICs").

Section 201. Credit For Tax Paid By REIT On Retained Capital Gains.

Current law taxes a REIT that retains capital gains, and imposes a second level of tax on the REIT shareholders when later they receive the capital gain distribution. H.R. 1150 provides for the REIT rules to be modified to correspond with the mutual fund rules governing the taxation of retained capital gains by passing through a credit to shareholders for capital gains taxes paid at the corporate (REIT) level. This modification is necessary to prevent the unintended depletion of a REIT's capital base when it sells property at a taxable gain. Accordingly, the REIT could acquire a replacement property without incurring costly charges associated with a stock offering or debt.

Section 202. Reduction in the 95% Distribution Requirement.

H.R. 1150 calls for reducing the REIT distribution requirement of taxable ordinary income from 95% to 90%. RICs have a similar distribution requirement, which is set at 90%. The REIT distribution requirement was 90% from 1960 until 1976. As part of the Tax Reform Act of 1976, REITs were granted a special "deficiency dividend procedure" designed to protect their status in the face of a redetermination of distributable income pursuant to an IRS audit. In exchange for this decreased risk of inadvertent disqualification, REITs were asked to distribute a higher percentage of their income. However, when the deficiency dividend procedure was extended to RICs in 1978, no corresponding change was made to the RIC distribution requirement. Accordingly, H.R. 1150 calls for a reduction in the REIT distribution requirement to restore conformity between REITs and RICs.

C. Title III of REITSA would simplify several technical problems that REITs face in their organization and day-to-day operations. Many of these proposals would build on simplifications that Congress has adopted over the years.

Section 301. Modification Of Earnings And Profits Rules For Determining Whether REIT Has Earnings And Profits From Non-REIT Year.

Only for purposes of the requirement that a REIT distribute all pre-REIT earnings and profits ("E & P") within its first taxable year as a REIT, a REIT's distributions should be deemed to carry out all pre-REIT earnings before shareholders are considered to be receiving REIT E & P. Under existing law, a REIT must not only distribute 95% of its REIT taxable income to shareholders, but it must in its first year distribute all pre-REIT year E & P. If the company mistakenly underestimates the amount of E & P generated while operating as a REIT it may fail to satisfy those requirements because the ordering rules controlling the distribution of E & P currently provide that distributions first carry out the most recently accumulated E & P. Thus, if a REIT distributes the pre-REIT E & P and the expected REIT E & P in its first REIT taxable year, the year-end receipt of any unanticipated income would result in the reclassification of a portion of the distribution intended to pass out the pre-REIT E & P.

While REITs have methods available to make distributions after the close of their taxable year that relate back to assure satisfaction of the 95% income distribution requirement (to be changed to 90% under REITSA), those methods can not be used to cure a failure to distribute pre-REIT E & P after the close of the REIT's taxable year. Accordingly, by allowing the REIT's distributions to first carry out the pre-REIT E & P, the REIT could satisfy both distribution requirements by using one of the deferred distribution methods to distributed the unanticipated income discussed in the example.

Section 302. Treatment Of Foreclosure Property.

Rules related to foreclosure property should be modernized. For property acquired through foreclosure on a loan or default on a lease, under present law a REIT can elect foreclosure property treatment. That election provides the REIT with 3 special conditions to assist it in taking over the property and seeking its re-leasing or sale. First, 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 must use an independent contractor to conduct the trade or business (a party from whom the REIT does not receive income). Second, a REIT may hold foreclosure property for resale to customers without being subject to the 100% prohibited transaction tax (although subject to the highest corporate taxes). Third, non-qualifying income from foreclosure property (from activities conducted by the REIT or independent contractor after 90 days) is not considered for purposes of the REIT gross income tests, but generally is subject to the highest corporate tax rate. The foreclosure property election is valid for 2 years, but may be extended for 2 additional terms (a total of 6 years) with IRS consent. Under H.R. 1150, the election procedure would be modified in the following ways: (1) the initial election and one renewal period would last for 3 years; (2) the initial election would remain effective until the last day of the third taxable year following the election (instead of exactly two years from the date of election); and (3) a one-time election out of foreclosure property status would be made available to accommodate situations when a REIT desires to discontinue foreclosure property status.

In addition, the independent contractor rule under the election would be modernized so that it worked in the same manner as the general independent contractor rule. Currently, a REIT may provide to tenants of non-foreclosure property services customary in the leasing of real property. However, this previous modernization of the independent contractor rule was not made to the rules governing the required use of independent contractors for foreclosure property.

Section 303. Special Foreclosure Rules For Health Care Properties.

In the case of health care REITs, H.R. 1150 provides that a REIT would not violate the independent contractor requirement if the REIT receives rents from a lease to that independent contractor as a tenant at a second health care facility. This change recognizes the limited number of health care providers available to serve as an independent contractor on a property acquired by the REIT in foreclosure, and the REIT's likely inability to simply close the facility due to the nature of the facility's inhabitants.

In addition, the health care rules would extend the foreclosure property rules to expirations or terminations of health care REIT leases, since similar issues concerning a limited number of operators arise in those circumstances. However, foreclosure property treatment in these cases would be limited to a two-year period, unless the Secretary grants one or two possible two-year extensions.

Section 304. Payments Under Hedging Instruments.

H.R. 1150 would extend the REIT variable interest hedging rule to permit a REIT to treat as qualifying any income from the hedge of any REIT liability secured by real property or used to acquire or improve real property. For example, this provision would apply to hedging a REIT's unsecured corporate debenture or the currency risk of a debt offering denominated in a foreign currency.

Section 305. Excess Noncash Income.
H.R. 1150 would expand the use of the excess noncash income exclusion currently provided under the REIT distribution rules. The bill would (1) extend the exclusion to include most forms of phantom income and (2) make the exclusion available to accrual basis REITs. Under the exclusion, listed forms of phantom income would be excluded from the REIT 90% distribution requirement. However, the income would be taxed at the REIT level if the REIT did not make sufficient distributions. **Section 306. Prohibited Transaction Safe Harbor.** H.R. 1150 would correct a problem in the wording of Congress' past liberalization of the safe harbor from the 100% excise tax on prohibited transactions, i.e., sales of property in the ordinary course of business. Involuntary conversions of property no longer would count against the permitted 7 sales of property under the safe harbor. **Section 307. Shared Appreciation Mortgages ("SAM").** In general, section 856(j) provides that a REIT may receive income based on a borrower's sale of the underlying property. However, the character of that income is determined by the borrower's actions. The SAM provision would be modified and clarified so that a REIT lender would not be penalized by a borrower's bankruptcy (an event beyond its control) and would clarify that a SAM could be based on appreciation in value as well as gain. **Section 308. Wholly Owned Subsidiaries.** In 1986, Congress realized the usefulness of a REIT holding properties in subsidiaries to limit its liability exposure. H.R. 1150 would codify an IRS private letter ruling position providing that a REIT may treat a wholly-owned subsidiary as a qualified REIT subsidiary even if the subsidiary previously had been owned by a non-REIT entity. H.R. 1150 would allow a REIT to treat a corporation as a qualified REIT subsidiary when it acquires for cash and/or stock all the stock of a non-REIT C or S corporation. The effective date would be for taxable years beginning after the date of enactment.