November 11, 2005

national policy bulletin

National Association of Real Estate Investment Trusts®

BACKGROUND

On January 7, 2005, President Bush established the Advisory Panel on Federal Tax Reform (the Panel). President Bush charged the bipartisan panel with recommending reforms to the tax code that would make the U.S. tax system simpler, fairer and more growth oriented.

After holding hearings around the country, on November 1, 2005 the Panel released two tax reform plans: the Simplified Income Tax option and the Growth and Investment Tax Plan. Both proposals would impose a corporate level tax on "pass-through entities" such as partnerships, repeal the deduction for state and local taxes, significantly limit the deduction for home-mortgage interest and jettison the alternative minimum tax. CLICK HERE to obtain the details of the Panel's recommendations.

This *National Policy Bulletin* summarizes the Panel's major recommendations and those having the most relevance to commercial real estate.

Tax Reform Panel Recommendations

Simplified Income Tax Option.

Individuals

- Create four income-tax brackets of 15%, 25%, 30% and 33%, which is below the current top rate of 35%;

- Reduce the tax on capital gains from the sale of stock of U.S. corporations to 25% of the ordinary income-tax rate, or a top rate of 8.25%, down from today's 15%. Capital gains attributable to other assets, *e.g.*, real estate, would be subject to ordinary income rates;

- Exclude from income all dividends of U.S. companies paid out of domestic earnings;

- Replace the mortgage-interest deduction with a tax credit equal to 15% of mortgage interest paid on primary residences (*i.e.*, no deduction on interest paid for secondary residences), but limited to interest on mortgages between $227,000 and $412,000, depending on the geographic region (based on the FHA loan allowance) (transition rules would apply);

1875 Eye Street NW, Suite 600, Washington, DC 20006-5413 • 202-739-9400, 800-3NAREIT • 202-739-9401 fax • www.nareit.com

▪ Increase the current exclusion of gain from a primary residence to $600,000 for a married couple, while increasing the length of time an individual must own and use a home as a principal residence from two out of five years to three out of five years. Gains over that amount would be taxable at ordinary income rates;

▪ Eliminate the current deduction of state and local taxes, including property taxes;

▪ Eliminate the exclusion of employer-provided fringe benefits other than health insurance;

▪ Impose a new tax-free limit on the premiums for health insurance provided tax-free by employers of about $11,500 for families, $5,000 for individuals;

▪ Simplify tax breaks for saving patterned along the lines of President Bush's savings proposals;

▪ Allow all taxpayers to deduct charitable contributions exceeding 1% of their income;

▪ Eliminate the alternative minimum tax (AMT); and,

▪Shrink the Form 1040 tax return by over one-half.

Businesses

For large business entities with more than $10 million of receipts, this option would: 1) reduce the top corporate-tax rate to 31.5% from 35%; 2) eliminate the corporate alternative minimum tax; and, 3) eliminate the tax on profits from active businesses overseas -- allowing firms to repatriate overseas profits tax-free. Under this alternative, ALL flow-through entities, including partnerships, S corporations, and limited liability companies would be subject to a corporate level tax.

However, the Panel's report states that "[p]assive investment vehicles, such as regulated investment companies (RICs) and real estate investment trusts (REITs), would continue to be treated the same as under current law."

Businesses with annual revenues over $10 million would depreciate assets under a simplified cost recovery system under which all assets are written off in one of four categories. Residential buildings would be depreciated 3% per year and non-residential buildings would be depreciated 4% per year. Unspecified transition rules for existing properties may apply. Businesses could continue to deduct interest expenses for tax purposes under this option.

Growth and Investment Tax Plan. The alternative proposal would shift the U.S. tax code toward taxing spending rather than income, in an effort to encourage saving and spur investment and economic growth.

Individuals

This option would incorporate many features of the other proposal with two major exceptions. It would have three tax brackets for individuals: 15%, 25%, and 30%. Further, it would impose a flat 15% tax on dividends, capital gains and interest.

Businesses

At the corporate level, all entities (including REITs) other than sole proprietorships would be taxed at 30% of their cash flow. Capital investment would be immediately expensed but there would be no deduction for interest expense. Unlike the first option, real estate investment apparently would be immediately expensed. Transition rules would be put into place as well. Again, the corporate AMT would be repealed.

The Panel stated that there a number of open issues under this alternative, including how "financial services" would be taxed under this regime.

OUTLOOK

Any action on the Panel's proposals may be delayed by concerns related to the growing federal deficit, and industries that would be adversely impacted by the Panel's recommendations have begun to vigorously oppose any such recommendations. For example, the National Association of Realtors already has voiced significant opposition to the potential cutback of the mortgage interest deduction, claiming that it could cause a decrease of 15% in housing prices. Similarly, the American Council of Life Insurers has expressed opposition to the proposals, stating that it would set "arbitrary limits on the ability of Americans to protect their families through life insurance and annuities."

NAREIT will continue to monitor both the Administration's and Congress' response to the Panel's recommendations.

For further information, please contact Dara Bernstein, dbernstein@nareit.com or Tony Edwards, tedwards@nareit.com.