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Changes to REIT Related Provisions Proposed in the Tax Reform Act of 2014 and in the 2015 Budget Proposal

The following is a summary of certain proposed changes to the Real Estate Investment Trust ("REIT") provisions of the Internal Revenue Code included in recent legislative proposals.

After several months of hearings on comprehensive tax reform, on February 26, 2014, Representative David Camp, chair of the House Ways and Means Committee, released draft legislation referred to as the Tax Reform Act of 2014 that proposes to amend major portions of the Internal Revenue Code to provide for comprehensive tax reform. On March 4th, President Obama released his Budget Proposals for 2015. Although neither the Tax Reform Act of 2014 nor the Budget Proposal have been formally introduced as a bill, and the prospects for passage of either set of proposals is uncertain at this point, given the significant nature of the proposed reforms, we will monitor their progress and provide updates as warranted.

We have also prepared summaries of other provisions included in these legislative proposals relevant to other topical areas - please check our website for those.

Distributions by REITs

Both the Camp Proposal and the Budget Proposal would revise the treatment of certain rules applicable to distributions by REITs.

Repeal of Preferential Dividend Rule for Public REITs

REITs are generally allowed to deduct dividends paid to their shareholders. In order to qualify for deduction, the dividend generally must be distributed pro rata, without preferences among shares or classes of stock except for preferences applicable by charter to an entire class. It is often unclear whether a difference as to timing or other mechanics gives rise to a preference, and REITs with publicly traded stock are limited in their ability to pay dividends other than in accordance with their charter (thereby complicating efforts to remediate inadvertent preferences).

Both the Camp Proposal and the Budget Proposal would repeal this deduction disallowance for "publicly offered" REITs.

- Under the Camp Proposal, a publicly offered REIT is one that is required to file annual and periodic reports with the SEC.
- The Budget Proposal includes a similar definition but would also require that the distribution be paid with respect to stock that is or has been the subject of a SEC filed registration statement and, if not currently publicly traded, no more than one-third of the voting power of the REIT be held by a single person (taking into account attribution rules).
- Both proposals also give the Secretary of the Treasury authority to provide for cures of inadvertent violations of the preferential dividend rule by non-public (i.e. private) REITs.

Distributions of non-REIT Earnings Must be in Cash

An entity cannot qualify as a REIT for a taxable year unless as of the close of such taxable year, the REIT has no earnings and profits accumulated in prior non-REIT years.

- In order to purge accumulated non-REIT earnings, some REITs took advantage of IRS rulings that allow corporations to treat non-pro rata distributions of REIT stock as distributions of property.
- The Camp Proposal would require that all distributions used to purge accumulated non-REIT earnings and profits be paid in cash.

Prohibition on Tax Free Spinoffs Involving REITs

If a distribution of subsidiary stock qualifies as a tax free spinoff, there is no tax to the distributing corporation or to the receiving shareholders.

One requirement to qualify is that both the distributing and distributed corporations be engaged in the active conduct of a trade or business. Recent IRS rulings have interpreted this requirement in a manner that is favorable to REITs seeking to make distributions of, and to corporations seeking to create REITs by, spinning off existing real estate portfolios.

The Camp Proposal would amend the Code to:

- make clear that tax free spin off treatment does not apply if either the distributing or distributed corporation is a REIT; and
- prohibit a spun off corporation from making a REIT election for 10 years.

Taxable REIT Subsidiaries

TRS Limit Reduced from 25% to 20%

REITs are subject to limitations on the composition of their assets and generally may not own more than 10% of the voting power or value of a single entity. One exception allows REITs to hold up to 25% percent of their gross assets in the stock of subsidiaries taxed as corporations (each referred to as a taxable REIT subsidiary or "TRS").

- In 2008 this limit was increased from 20% to 25%.
- Under the Camp Proposal, the asset ownership limit would be reduced back to 20% for tax years beginning after 2016.

Non-Arm's Length Transactions

REITs and their TRSs are subject to a 100% prohibited transaction tax on certain transactions between them if determined not to be arm's length by the IRS.

- This tax currently applies to "redetermined" rents, interest and certain deductions paid by a TRS to its REIT (thereby reducing income otherwise subject to corporate income tax).
- The Camp Proposal would expand the prohibited transaction tax so that it applies to "redetermined TRS service income," which would encompass underpayments of amounts by a REIT to its TRS for services rendered by the TRS to or for the benefit of the REIT.

REIT Asset and Income Tests

Short Lived Assets Not Real Estate

Under the REIT regulations, real property includes land and improvements thereto and "improvements" has generally focused on whether an item is inherently permanent and part of the structure rather than ancillary to the structure.

- Several rulings have concluded that certain types of property eligible for depreciation and potentially eligible other tax benefits applicable to personal property constitute real property when owned by a REIT (e.g. cell towers and solar systems).
- The Camp Proposal would exclude tangible property that has a class life of less than 27.5 years from the definition of real property for REIT purposes.
- On the other hand, the Camp Proposal would allow ancillary personal property that is leased with real property (or that is mortgaged with real property) to be treated as real property so long as it does not exceed 15% of the total fair market value of the combined real and personal property.

Rents and Interest Based on Gross Receipts

For purposes of the REIT gross income tests, rents and interest that are contingent on the payor's income or profits generally do not qualify as good REIT income but contingent rents and interest based on a fixed percentage of gross receipts or sales do qualify.

- Under the Camp Proposal if fixed percentage rents and interest derived from one or more affiliated tenants that are C corporations constitutes more than 25% of fixed percentage rents or more than 25% of fixed percentage interest earned by such REIT, then none of the fixed percentage rents or interest from such person or its affiliates would qualify as good REIT income.

Other Provisions Applicable to REITs

Camp Proposal: There are numerous other positive and negative changes to the REIT rules included in the Camp Proposal, including provisions to:

- Permit debt obligations issued by publicly offered REITs to qualify as real estate assets (even if not secured by real property) so long as such debt obligations do not exceed 25% of the fair market value of the REITs assets in the aggregate;
- Permit income from replacement hedges entered into in connection with extinguished debt or disposed

property to be disregarded when computing the gross income tests applicable to REITs;

- Modify the rules for computing REIT E&P and for designating dividends to avoid duplication;
- Require immediate recognition of built in gain when a C corporation converts to a REIT;
- Extend the waiting period to re-elect REIT status after a termination from 5 to 10 years
- Repeal the special rules that allowed standing timber to qualify as real property and that limited application of the prohibited transaction tax
- Modify the provision of FIRPTA that excludes from the definition of US real property interest stock in a corporation that does not predominantly own real property or that has disposed of such real property so that it does not apply to corporations that are or were REITs (but the exception for publicly traded stock in REITs would continue to apply); and
- Exclude REIT dividends earned by a foreign subsidiary of a US corporation from the income that is eligible for a dividends received deduction in the hands of such US corporation.

Budget Proposal: Most of the proposed changes to the REIT rules that are included in the Camp Proposal are not included in the Budget Proposal. However, the Budget Proposal does specifically mention expanding certain tax benefits so that they are also available to REITs, including:

- the low income housing tax credit; and
- the deduction for energy efficiency improvements

For More Information

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