NAREIT Issue Summary

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PRESIDENT BUSH RELEASES NEW TAX PROPOSALS

Executive Summary

President Bush has released the broad outlines of the Administration's $674 billion growth and jobs plan. The centerpiece proposal would exclude from an individual's taxable income all of the dividends he or she receives each year from corporations to the extent that the corporation has paid tax. Since REITs generally do not pay corporate taxes, the top tax official in the Treasury Department has confirmed that this exclusion generally would not apply to REIT dividends. Further, it appears that the proposal would permit most corporations to retain after-tax proceeds while providing shareholders a stock basis increase as if a dividend was paid and reinvested in the corporation's stock. To the extent a REIT pays corporate taxes (whether through a taxable REIT subsidiary or by retaining up to 10% of taxable income), we believe the same or similar treatment will be accorded REITs.

Dividend Exclusion

Prior law

From 1954 through 1986, the tax code exempted various amounts of dividends from taxation to partially alleviate double taxation: once when earned by a corporation and again when distributed to the shareholder. Beginning with the creation of REITs in 1960, REIT dividends were not exempted because REITs generally are not subject to a corporate level of taxation.

Administration's Proposal Generally

The President's proposal would exempt from income taxation dividends shareholders receive only to the extent that the distributed earnings had been subject to a corporate level of tax. To limit the exclusion to previously-taxed amounts, corporations would be required to maintain excludable distribution accounts (EDAs). Only distributions from these EDAs would be excluded from the shareholder's income. Based on this theory, the Assistant Treasury Secretary (Tax Policy) has stated that REIT dividends that were not subject to a corporate level of tax would not be excluded from shareholders' income under the President's proposal.

With the top marginal rate proposed to be reduced to 35% (the same rate as for the corporate income tax), the Administration's proposal would equalize the maximum taxes paid by corporations and individuals. However, the tax rate on income generated by a non-REIT C corporation and paid to shareholders subject to a lower rate would be higher than the same income generated by a REIT and distributed to those same shareholders.

Distribution Requirement

The Administration's dividend exclusion proposal is not contingent on any minimum distribution requirement. Therefore, investors seeking yield

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would not be assured that non-REITs would maintain or increase dividends (although some shareholders could bring increased pressure on corporations to increase their dividend distributions if the after-tax yield would be increased). Conversely, a REIT is required to distribute at least 90% of its taxable income every year, and most REITs tend to distribute more than the minimum. Accordingly, investors interested in more reliable cash yields should continue to be attracted to REIT securities. In addition, investors who continue to be attracted to the important role real estate plays to diversify their portfolios would continue to be attracted to REITs because by law REITs must be mostly invested in real estate.

Impact of Proposal on Cash Distributions

Dividends paid by non-REITs would not decrease those companies' corporate tax obligations (unlike interest payments on debt). It is not clear what impact a shareholder exclusion would have on non-REITs' distribution policies.

Further, the Administration's proposal would permit a corporation to "deem" a dividend paid and then reinvested in the corporation's stock. This "deemed" dividend/reinvestment would increase the shareholder's basis in the stock in much the same way that a REIT can retain capitalgains proceeds and provide a tax-free stock basis increase to its shareholders since the REIT Modernization Act of 1999. Any deemed dividends would be subtracted from a corporation's EDA. To the extent that non-REIT C-corporations use this deemed dividend mechanism, investors interested in receiving cash dividends would continue to be more attracted to REITs.

More details of the Administration's tax proposals will be available when the formal Fiscal Year 2004 Budget is released in the first week of February.