national policy
bulletin
National Association of Real Estate Investment Trusts®

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President Bush Releases New Tax Proposals

Executive Summary

President Bush released yesterday 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.

The proposals also would accelerate the already-enacted income tax rate cuts scheduled to take effect in 2004 and 2006 to 2003, including a decrease in the top marginal rate from 38.5% to 35%.

The package includes a number of other significant tax reductions, including increased expensing for small businesses and increased child care tax credits, as well as increased spending such as extending unemployment insurance coverage that expired on December 31, 2002.

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[1]. Based on this theory, yesterday the Assistant Treasury Secretary (Tax Policy) 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

[1] For a more detailed explanation of EDAs, as well as a detailed analysis of the White House proposal, see page 6 of http://www.whitehouse.gov/cea/dividend_exclusion_briefing_paper.pdf

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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 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, because of the important role real estate plays to diversify portfolios, investors should continue to be drawn 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 capital gains 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.

REIT Issues

Although not yet confirmed, we understand that taxes paid by a taxable REIT subsidiary could be eligible for the deemed distribution/recontribution election discussed above. Similarly, we understand that a REIT that distributes less than 100% of its taxable income could choose to pay tax on the undistributed amount and then make a tax-free distribution of the retained amount or make a deemed distribution/recontribution election to increase shareholders' tax basis in their REIT stock.

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.

Acceleration of Rate Cuts and Alternative Minimum Tax Relief

The Administration proposes to accelerate the tax rate reductions from the 2001 tax law to January 1, 2003 from 2004 and 2006. The Administration also proposes accelerating to 2003 the expansion of the 10% tax bracket (from taxable income of $12,000 to $14,000 for married couples). As a result, the new rate brackets would be 10%, 15%, 25%, 28%, 33%, and 35%. Withholding rates would be altered immediately to reflect these lower tax rates. In an attempt to prevent the benefits from the tax rate reductions from causing individuals to become subject to the "alternative minimum tax" or "AMT," the AMT exemption amount would be increased by $8,000 for married taxpayers and by $4,000 for single taxpayers in 2003 through 2005. This proposed lowering of tax rates on individuals decreases the taxes paid on income generated by a REIT.

Additional Components

The Administration's proposal contains several other provisions. For example, the proposal would accelerate reduction of the so-called "marriage penalty," increasing the standard deduction for married couples to double that of single taxpayers in 2003. Further, the increase in the child tax credit (from $600 per child to $1,000 per child) would be accelerated to 2003. Finally, the Administration proposes to increase from $25,000 to $75,000 the amount of new investment small businesses may immediately deduct, phased out for small businesses with investment in excess of $325,000 to $400,000.

Future of These Proposals

It is important to recognize that the Administration's tax proposals are but the first step in the legislative process. Both the House and Senate must pass tax bills, and they then must be reconciled if different. Certain procedural rules in the Senate require 60 votes to pass tax legislation in most circumstances, which provides the 49 Democratic Senators significant influence on a tax bill's contents. To avoid the need for 60 votes, it is quite possible that Senate Republicans will want the Administration's tax proposals to be enacted as part of a budget reconciliation bill, which requires just a majority vote in the Senate. However, several senators, including at least one Republican, have stated their opposition to the President's dividend proposal. As you would expect, there will be intensive legislative maneuvering between both parties in the coming months.

NAREIT will stay closely involved in the legislative process and keep you informed as these proposals evolve.

If you have any questions about these issues, please contact Tony Edwards at tedwards@nareit.com or Dara Bernstein at dbernstein@nareit.com.