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national policy

bulletin

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

TAX BILLS MOVE FORWARD IN CONGRESS

DIFFERING DIVIDEND PROPOSALS ADVANCE - REIT DIVIDEND TREATMENT LEFT LARGELY UNCHANGED

Executive Summary

Today the House of Representatives approved a tax bill that incorporates most of President Bush's jobs and growth tax initiative. However, the measure replaces his proposal to eliminate the double taxation of corporate dividends with a maximum 15% tax rate on most corporate dividends and capital gains, beginning in 2003.

Essentially, the dividend proposal passed by the House provides about half of the dividend tax relief contained in the President's plan while eliminating the Administration's architecture intended to limit tax relief to the amount of taxes actually paid by a corporation. As expected, the reduced tax rate in the House bill does apply to REIT dividends, but only to the extent a REIT receives and passes through to its shareholders dividends from taxable REIT subsidiaries or other tax-paying corporations. Capital gains from the sale of REIT stock as well as capital gain distributions from a REIT would be eligible for the new 15% maximum capital gain rate (except to the extent attributable to depreciation recapture, which remains subject to a 25% tax rate).

Yesterday, the Senate Finance Committee approved a tax bill that also incorporates most of President Bush's proposal, but would, with respect to dividends, exclude the first $500 of dividends received from an individual's gross income starting in 2004, as well as another 10% of the dividends the individual receives above this threshold from 2004 through 2007 (and 20% over the $500 threshold from 2008 through 2012). Again, REIT dividends would benefit only to the extent the REIT received corporate dividends from a taxable REIT subsidiary or other non-REIT corporation. The Finance Committee bill also would place new ownership limits on certain "closely-held" REITs.

Both bills would accelerate the current timetable for reduction of individual tax rates to 2003.

House Passes Most of President Bush's Jobs and Growth Tax Relief Proposals

On May 9, 2003, the House of Representatives approved a $550 billion tax relief package based largely on President Bush's jobs and growth proposal. For text of the legislative language of H.R. 2, click HERE. For the Joint Committee on Taxation's Summary of the legislative language click HERE.

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Lower Tax Rates for Dividends and Capital Gains

As expected, the House's package did not incorporate President Bush's proposal to exclude dividends from income. Instead, H.R. 2 would lower the maximum tax rates on dividends and capital gains income to 15% beginning in 2003, through 2013, while leaving the tax rate on gain attributable to depreciation recapture at its current level of 25%. As with the President's original proposal, while REIT dividends in general do not qualify for the reduced rates, REIT dividends that are attributable to "qualified dividends" (*e.g.*, from taxable REIT subsidiaries or other non-REIT corporate dividends) received by a REIT would qualify for the new, lower rates on a proportionate basis. Furthermore, as under current law, REIT capital gain distributions (or undistributed capital gain income designated by the REIT) and gains attributable to the sale of REIT stock would qualify for the lower capital gain rates.

Rate Cut Acceleration

As with the President's original proposal, H.R. 2 would accelerate the individual income tax rate cuts scheduled for 2004 and 2006 to this year. Thus, for 2003 and later years, the maximum individual income tax rate would be 35%.

Increased Depreciation for Certain Leasehold Improvements

H.R. 2 also includes a provision that would provide an additional first-year depreciation deduction equal to 50% of the adjusted basis of "qualified property" placed in service after May 5, 2003, which includes second-generation leasehold improvements placed in service by January 1, 2007. The Job Creation and Worker Assistance Act of 2002 ("JCWAA") had allowed an additional first-year depreciation deduction equal to 30% of the adjusted basis of such property. H.R. 2 would increase the deduction to 50%. Property eligible for the 50% additional first year depreciation deduction would not be eligible for the 30% additional first year depreciation deduction.

Senate Finance Committee Approves Tax Bill With Limited Dividend Relief

On May 8, 2003, the Senate Finance Committee approved a tax bill (S. 2) with more limited dividend tax relief than either the President's proposal or H.R. 2 as passed by the House. Because the budget instructions passed by the Senate only allow for $350 billion in net tax relief (compared to $550 billion in the House), S. 2 includes about $83 billion in revenue offsets (tax or fee increases) to pay for the 10-year cost of S. 2 — pegged at $423 billion.

S. 2 would exclude the first $500 of dividends received from an individual's gross income starting in 2004, as well as 10% of the dividends the individual receives above this threshold from 2004 through 2007 (and 20% over the $500 threshold from 2008 through 2012). Since REITs are generally anticipated not to pay a corporate level tax, the proposed dividend exclusion does not apply to most REIT dividends. This is consistent with past treatment of REIT dividends in the tax code when it has contained a flat exemption amount for dividends only. However, the proposal would allow REITs to pass through dividends received from taxable REIT subsidiaries (TRSs) and other corporations as qualifying dividends on a proportionate basis. S. 2 also would accelerate the reduction in the individual tax rates to 2003, including a reduction in the maximum individual rate to 35% from 38.6%.

Closely-Held REITs

In the final moments of its consideration of the legislation on Thursday evening, the Finance Committee adopted a "manager's amendment" containing a number of provisions, including additional revenue "offsets." One of the revenue raising proposals is the "closely-held" REIT proposal that the Senate passed in 1999 but was not included in the final legislation passed by Congress. Under this proposal, a company would lose its REIT status if any person other than a REIT, a partnership 50% or more owned by a REIT, or a pension plan owns 50% or more of the vote or value of that company's stock. Click HERE for the 1999 statutory language. It appears that the provision was included primarily because it raises $50 million over 10 years and that amount was needed to partly pay for an acceleration of a child tax credit. Many legislators oppose any tax increase, and it is not clear whether this provision will survive the vote on the Senate floor, let alone the House-Senate conference committee. In the past, NAREIT did not oppose the aims of the closely-held REIT proposal so long as certain modifications were made to it. NAREIT will seek these modifications once again.

Several Senators are expected to attempt to amend S. 2 on the Senate floor to increase the dividend tax relief more along the lines of the President's proposal (but any tax bill approved must not exceed $350 billion on a net basis over 10 years). The Senate is expected to consider S. 2 during the week of May 12.

Focus On REIT Investment

- Although, as expected, the treatment of REIT dividends is left largely unchanged by these proposals, both H.R. 2 and S. 2 highlight dividend-paying equities, which some believe could be a positive development for REITs.

- Also, it is important to note that the Administration's proposal aimed to exclude 100% of qualifying dividends, while the House bill is largely equivalent to a 57% exclusion and the Senate bill amounts to no more than a 20% exclusion for dividends above $500. Of course, whether the President's concepts for dividend tax relief are reinstated and how much relief will be provided can only be known after a House-Senate conference committee completes its work.

- Since REITs must pay dividends and regular corporations are not required to do so — and neither of these bills include such a requirement — REIT dividend yields are likely to remain far more attractive than other companies to yield-oriented investors. This is particularly true for taxpayers in the lower income tax brackets or those investing to plan for retirement.

- Finally, because of REITs' required ownership of real estate-related assets and their reliable performance over three decades, REITs provide proven diversification benefits to investment portfolios irrespective of relative tax rates.

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
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