NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

Statement of the

National Association of Real Estate Investment Trusts®

to the

Subcommittee on Select Revenue Measures
Of the Committee on Ways and Means

Regarding the Hearing To Be Held November 16, 2005 on

Member Proposals on Tax Issues Introduced in the 109th Congress

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The National Association of Real Estate Investment Trusts® (NAREIT) respectfully submits these comments in connection with the hearing of the Subcommittee on Select Revenue Measures of the Committee on Ways and Means to be held on November 16, 2005, regarding individual tax proposals introduced in the 109th Congress. NAREIT thanks the Chairman and the Subcommittee for the opportunity to provide these comments.

NAREIT is the representative voice for United States real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

EXECUTIVE SUMMARY

By way of background, the American Jobs Creation Act of 2004 (Jobs Act) shortens the depreciation recovery period with respect to qualified leasehold improvements placed in service before January 1, 2006 from 39 years to 15 years. NAREIT appreciates Congress' leadership in enacting this important legislation, and NAREIT supports a permanent extension of this 15-year recovery period.

On April 14, 2005, Rep. Clay Shaw (R-FL) introduced H.R. 1663, which would enact a permanent extension of the 15-year recovery period for second-generation leasehold improvements. This bill now has a total of 27 co-sponsors. However, because of certain tax rules applicable to REITs, particularly concerning the calculation of "earnings and profits" (E&P), the intended benefits associated with the shortened recovery period will not be passed on to REIT shareholders. Additionally, REITs may face the possibility of failing to meet the distribution requirement to maintain their REIT status.

Accordingly and as further described below, in the event that the 15-year life of tenant improvements is extended another year or if the H.R. 1663 legislation becomes law (or there are other changes to the calculation of depreciation generally), NAREIT respectfully requests that Congress consider a conforming modification to the calculation of E&P to allow 15-year leasehold depreciation treatment to flow through to REIT shareholders (or similar conforming modifications to the calculation of a REIT's E&P in order that the calculation of taxable income conform to the calculation of E&P) and to avoid the risk of REITs' failing to meet the distribution requirement.

DISCUSSION

Background

In general, depreciation is determined under the modified accelerated cost recovery system (MACRS) as provided under § 168 of the Internal Revenue Code of 1986, as amended (the Code). Prior to the Jobs Act, § 168 provided that leasehold improvements were depreciated over 39 years for tax purposes, regardless of whether the improvements were made by the lessor or

the lessee or whether the recovery period for the improvement was longer than the term of the lease.

A 39-year recovery period for leasehold improvements extends well beyond the useful life of the investments, and leases of commercial real estate typically are shorter than the 39-year recovery period. Therefore, the Jobs Act shortens the recovery period for qualified leasehold improvement property that is placed in service before January 1, 2006 to a more realistic period of 15 years because Congress believed that taxpayers should not be required to recover the costs of certain leasehold improvements beyond the useful life of the investment. Although lease terms differ, a uniform period of 15 years for recovery of qualified leasehold improvements was chosen in the interests of simplicity and ease of administration. *See* H.R. Rep. No. 548, 108th Cong., 2d Sess. 122 (2004). NAREIT strongly supported this provision and believes it should be made permanent.

Issue

A REIT is a corporation or business trust combining the capital of many investors to own, operate or finance income-producing real estate, such as apartments, shopping centers, offices and warehouses. Congress created the REIT structure in 1960 to make investments in large-scale, significant income-producing real estate accessible to investors from all walks of life. The shareholders of REITs unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors: greater diversification through investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals.

REIT shareholders may receive income from investments in real property without the income being subject to taxation at the entity level. However, REITs are required to comply with several investment and operational requirements in order to maintain REIT status. For example, REITs are required to distribute at least 90% of their taxable income to their shareholders pursuant to § 857 of the Code and must pay tax on any taxable income that they do not distribute. Specifically, the REIT's deduction for dividends paid must equal or exceed 90% of its taxable income, after certain adjustments not relevant here. C corporations have no such distribution requirement. REIT shareholders are particularly conscious of the REIT distribution requirement and the benefit of REIT dividends. In fact, over the last 20 years, dividends have represented approximately 2/3 of the REIT industry's annual compound total return, as measured by the NAREIT Equity REIT Index.

Because a REIT is not itself a pass-though entity (*e.g.*, REIT losses cannot be passed through to shareholders), the only mechanism for obtaining the pass-through effect is the deduction for dividends paid by the REIT. In general, only distributions of money or property out of accumulated or current E&P are included in the dividends paid deduction.[1]

[1] *See* §§ 562 and 316.

For purposes of determining the amount of a distribution that constitutes a dividend and, thus, the amount eligible for the dividends paid deduction, REITs generally are required to calculate their E&P pursuant to § 312.[2] In many instances, REITs make distributions at or above their current E&P levels (as well as above their current taxable income) in order to minimize entity-level federal tax liability and to meet shareholder investment-return expectations. Hence, it is typical for REITs to have little or no accumulated E&P.

While REITs are entitled to depreciate qualified leasehold improvement property over the shortened recovery period of 15 years, the corresponding recovery period for E&P purposes was not shortened by the Jobs Act beyond 39 years.[3]

This difference in recovery periods for qualified leasehold improvement property could, if the 15-year life of such property is extended as we believe it should be, potentially have a negative effect on REIT shareholders and prevent the intended benefits associated with the shortened recovery period from being realized.

For example, a REIT claims depreciation deductions on qualified leasehold improvement property over 15 and 39 years, respectively, in determining its taxable income and E&P. The potentially negative effect of not conforming taxable income and E&P depreciation deductions can be illustrated by the effects that may occur during years 1-15 of the depreciation recovery period and years 16-39 of the depreciation recovery period, respectively, as set forth below.

Years 1-15: Shareholders' Taxable Dividends May Exceed REIT's Taxable Income

Excluding other E&P adjustments, the REIT will have less taxable income than its E&P during the first 15 years due to the shorter recovery period for taxable income. Because the taxability of distributions to shareholders is based on E&P which has a much longer recovery period of 39 years, essentially, REIT E&P will be "artificially" high, thereby resulting in the shareholders' paying tax on an amount of income that exceeds the amount of income earned by the REIT. Thus, REIT shareholders will not realize the intended benefits associated with the shortened recovery period of 15 years.

Years 16-39: Possible Failure to Meet 90% Distribution Test/Shareholders' Taxable Dividends May Continue to Exceed REIT's Taxable Income

When such qualified leasehold improvement property is fully depreciated after 15 years, the REIT's taxable income subsequently will be greater than its E&P because of continuing depreciation deductions for E&P purposes that are no longer occurring for purposes of calculating taxable income. To the extent the difference caused by the different recovery periods is substantial, the REIT that typically distributed in excess of taxable income in the past (thereby eliminating its E&P in such years) may face a situation in which its E&P is less than 90% of its

[2] *See* Treas. Reg. § 1.856-1(c)(6) and (7).
[3] §§ 312(k)(3)(A), 168(g)(3)(B). See also § 168(e)(3)(E)(iv).

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taxable income. Because its deduction for dividends paid is limited by its E&P, the REIT may fail to have a deduction for dividends paid equal to at least 90% of its taxable income.[4]

Furthermore, the effect on REIT shareholders noted above could continue: REIT E&P could be "artificially" high, thereby resulting in the treatment of an "artificially" greater portion of shareholders' distributions as taxable dividends.[5] Thus, in a worst case scenario, the difference in recovery periods may cause a REIT to lose its REIT status and be subjected to tax at both the entity and shareholder levels.

Proposed Solution

When Congress enacted the shortened 15-year depreciation period for leasehold improvements last year, it is unlikely that the effects on REITs and their shareholders described above were intended or contemplated.

Accordingly, we respectfully request that any further extension of the 15-year recovery period for qualified leasehold improvement property be accompanied by an amendment to Code § 168(g)(3)(B) to provide a corresponding 15-year recovery period to qualified leasehold improvement property for E&P purposes. Similarly, we request that any change to the calculation of depreciation be matched with a conforming amendment to the calculation of a REIT's E&P.

NAREIT thanks the Subcommittee for the opportunity to submit these comments on this important issue.

[4] Section 857(d)(2) provides that a REIT will always be treated as having adequate earnings and profits to make distributions as dividends sufficient to avoid the excise tax under § 4981. The rules for determining the "required distribution" for purposes of avoiding the excise tax under § 4981 are complicated, but they basically require a distribution as a dividend of 85% of the REIT's ordinary income and 95% of the REIT's capital gain net income. Because § 857(d)(2) only ensures sufficient earnings and profits to avoid the excise tax and does not provide sufficient earnings and profits to meet the 90% distribution test under § 857(a)(1), it is possible that the REIT could fail the distribution test due to the depreciation of tenant improvements.

[5] If the increased depreciation of tenant improvements for earnings and profits purposes in years 16-39 require a REIT to invoke § 857(d)(2) so that it would have enough earnings and profits to avoid the excise tax under § 4981, this effective disallowance of depreciation would cause the REIT shareholders to report artificially high dividend income in those years. In addition, there is an alternate view that no deductions for depreciation are permissible against E&P in years 16-39 due to the application of § 857(d)(1) (which prohibits reducing E&P for any taxable year by an "amount" not "allowable" in computing taxable income for such year). If this view were correct, the REIT should not fail to meet its 90% distribution requirement. On the other hand, a REIT shareholder would be placed in an even worse position with the 15-year depreciation period than it is in with a 39-year depreciation period. Under this view, E&P would be reduced in years 1-15 based on a 39-year depreciation recovery period, but E&P would not be reduced at all in years 16-39, thereby greatly increasing the taxable portion of the REIT's distribution in the latter years. Thus, the shareholder could end up paying tax on income that greatly exceeds the income that is earned by the REIT.