

STATEMENT OF MANAGERS
ON
REVENUE PROVISIONS CONTAINED IN THE
CONFERENCE REPORT (H. REPT. 106-478)
TO ACCOMPANY H.R. 1180 RELATING TO
EXTENSION OF EXPIRED AND EXPIRING TAX PROVISIONS,
AND OTHER TAX PROVISIONS

November 17, 1999

achieve a particular tax result under present law, and no inference is intended that enactment of the provision limits the application of tax rules or principles under present or prior law.

I. Treatment of Real Estate Investment Trusts (REITs)

1. Provisions relating to REITs (secs. 852, 856, and 857 of the Code)

Present Law

A real estate investment trust (“REIT”) is an entity that receives most of its income from passive real-estate related investments and that essentially receives pass-through treatment for income that is distributed to shareholders.

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level. In general, a REIT must derive its income from passive sources and not engage in any active trade or business.

A REIT must satisfy a number of tests on a year by year basis that relate to the entity’s (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income. Under the source-of-income tests, at least 95 percent of its gross income generally must be derived from rents from real property, dividends, interest, and certain other passive sources (the “95 percent test”). In addition, at least 75 percent of its gross income generally must be from real estate sources, including rents from real property and interest on mortgages secured by real property. For purposes of the 95 and 75 percent tests, qualified income includes amounts received from certain “foreclosure property,” treated as such for 3 years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or on indebtedness which such property secured.

In general, for purposes of the 95 percent and 75 percent tests, rents from real property do not include amounts for services to tenants or for managing or operating real property. However, there are some exceptions. Qualified rents include amounts received for services that are “customarily furnished or rendered” in connection with the rental of real property, so long as the services are furnished through an independent contractor from whom the REIT does not derive any income. Amounts received for services that are not “customarily furnished or rendered” are not qualified rents.

An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT. In addition, a REIT cannot derive any income from an independent contractor.

Rents for certain personal property leased in connection with real property are treated as rents from real property if the adjusted basis of the personal property does not exceed 15 percent of the aggregate adjusted bases of the real and the personal property.

Rents from real property do not include amounts received from any corporation if the REIT owns 10 percent or more of the voting power or of the total number of shares of all classes of stock of such corporation. Similarly, in the case of other entities, rents are not qualified if the REIT owns 10 percent or more in the assets or net profits of such person.

At the close of each quarter of the taxable year, at least 75 percent of the value of total REIT assets must be represented by real estate assets, cash and cash items, and Government securities. Also, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities of any corporate issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.³⁵

Under an exception to the ownership rule, a REIT is permitted to have a wholly owned subsidiary corporation, but the assets and items of income and deduction of such corporation are treated as those of the REIT, and thus can affect the qualification of the REIT under the income and asset tests.

A REIT generally is required to distribute 95 percent of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies (“RICs”) that requires distribution of 90 percent of income. Both REITS and RICs can make certain “deficiency dividends” after the close of the taxable year, and have these treated as made before the end of the year. The regulations applicable to REITS state that a distribution will be treated as a “deficiency dividend” (and, thus, as made before the end of the prior taxable year) only to the extent the earnings and profits for that year exceed the amount of distributions actually made during the taxable year.³⁶

A REIT that has been or has combined with a C corporation³⁷ will be disqualified

³⁵ 15 U.S.C. 80a-1 and following. See Code section 856(c)(5)(F).

³⁶ Treas. Reg. sec. 1.858-1(b)(2).

³⁷ A “C corporation” is a corporation that is subject to taxation under the rules of subchapter C of the Internal Revenue Code, which generally provides for a corporate level tax on corporate income. Thus, a C corporation is not a pass-through entity. Earnings and profits of a C corporation, when distributed to shareholders, are taxed to the shareholders as dividends.

if, as of the end of its taxable year, it has accumulated earnings and profits from a non-REIT year. A similar rule applies to regulated investment companies (“RICs”). In the case of a REIT, any distribution made in order to comply with this requirement is treated as being first from pre-REIT accumulated earnings and profits. RICs do not have a similar ordering rule.

In the case of a RIC, any distribution made within a specified period after determination that the investment company did not qualify as a RIC for the taxable year will be treated as applying to the RIC for the non-RIC year, “for purposes of applying [the earnings and profits rule that forbids a RIC to have non-RIC earnings and profits] to subsequent taxable years.” The REIT rules do not specify any particular separate treatment of distributions made after the end of the taxable year for purposes of the earnings and profits rule. Treasury regulations under the REIT provisions state that “distribution procedures similar to those ... for regulated investment companies apply to non-REIT earnings and profits of a real estate investment trust.”³⁸

House Bill

No provision.

Senate Amendment

No provision, but S. 1792, as passed by the Senate, provides as follows:

Investment limitations and taxable REIT subsidiaries

General rule.--Under the provision, a REIT generally cannot own more than 10 percent of the total value of securities of a single issuer, in addition to the present law rule that a REIT cannot own more than 10 percent of the outstanding voting securities of a single issuer. In addition, no more than 20 percent of the value of a REIT’s assets can be represented by securities of the taxable REIT subsidiaries that are permitted under the bill.

Exception for safe-harbor debt.--For purposes of the new 10-percent value test, securities are generally defined to exclude safe harbor debt owned by a REIT (as defined for purposes of sec. 1361(c)(5)(B)(i) and (ii)) if the issuer is an individual, or if the REIT (and any taxable REIT subsidiary of such REIT) owns no other securities of the issuer. However, in the case of a REIT that owns securities of a partnership, safe harbor debt is excluded from the definition of securities only if the REIT owns at least 20-percent or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20 percent profits interest is to assure that if the partnership produces income

³⁸ Treas. Reg. sec. 1.857-11(c).

that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly through its partnership interest, even though it also may derive qualified interest income through its safe harbor debt interest.

Exception for taxable REIT subsidiaries.--An exception to the limitations on ownership of securities of a single issuer applies in the case of a “taxable REIT subsidiary” that meets certain requirements. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT or a qualified REIT subsidiary under section 856(i) that does not properly elect with the REIT to be a taxable REIT subsidiary) of which a taxable REIT subsidiary owns, directly or indirectly, more than 35 percent of the vote or value is automatically treated as a taxable REIT subsidiary.

Securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries could not exceed 20 percent of the total value of a REIT’s assets.

A taxable REIT subsidiary can engage in certain business activities that under present law could disqualify the REIT because, but for the proposal, the taxable REIT subsidiary’s activities and relationship with the REIT could prevent certain income from qualifying as rents from real property. Specifically, the subsidiary can provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and can manage or operate properties, generally for third parties, without causing amounts received or accrued directly or indirectly by the REIT for such activities to fail to be treated as rents from real property. However, rents paid to a REIT generally are not qualified rents if the REIT owns more than 10 percent of the value, (as well as of the vote) of a corporation paying the rents. The only exceptions are for rents that are paid by taxable REIT subsidiaries and that also meet a limited rental exception (where 90 percent of space is leased to third parties at comparable rents) and an exception for rents from certain lodging facilities (operated by an independent contractor).

However, the subsidiary cannot directly or indirectly operate or manage a lodging or healthcare facility. Nevertheless, it can lease a qualified lodging facility (e.g., a hotel) from the REIT (provided no gambling revenues were derived by the hotel or on its premises); and the rents paid are treated as rents from real property so long as the lodging facility was operated by an independent contractor for a fee. The subsidiary can bear all expenses of operating the facility and receive all the net revenues, minus the independent contractor’s fee.

For purposes of the rule that an independent contractor may operate a qualified lodging facility, an independent contractor will qualify so long as, at the time it enters into the management agreement with the taxable REIT subsidiary, it is actively engaged in the trade or business of operating qualified lodging facilities for any person who is not related to the REIT or the taxable REIT subsidiary. The REIT may receive income from such an independent contractor with respect to certain pre-existing leases.

Also, the subsidiary generally cannot provide to any person rights to any brand name under which hotels or healthcare facilities are operated. An exception applies to rights provided to an independent contractor to operate or manage a lodging facility, if the rights are held by the subsidiary as licensee or franchisee, and the lodging facility is owned by the subsidiary or leased to it by the REIT.

Interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules of section 163(j). Thus the taxable REIT subsidiary cannot deduct interest in any year that would exceed 50 percent of the subsidiary's adjusted gross income.

If any amount of interest, rent, or other deductions of the taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arm's length ("redetermined" items), an excise tax of 100 percent is imposed on the portion that was excessive. "Safe harbors" are provided for certain rental payments where (1) the amounts are de minimis, (2) there is specified evidence that charges to unrelated parties are substantially comparable, (3) certain charges for services from the taxable REIT subsidiary are separately stated, or (4) the subsidiary's gross income from the service is not less than 150 percent of the subsidiary's direct cost in furnishing the service.

In determining whether rents are arm's length rents, the fact that such rents do not meet the requirements of the specified safe harbors shall not be taken into account. In addition, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

The Treasury Department is to conduct a study to determine how many taxable REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries and shall submit a report to the Congress describing the results of such study.

Health Care REITS

The provision permits a REIT to own and operate a health care facility for at least two years, and treat it as permitted "foreclosure" property, if the facility is acquired by the termination or expiration of a lease of the property. Extensions of the 2 year period can be granted.

Conformity with regulated investment company rules

Under the provision, the REIT distribution requirements are modified to conform to the rules for regulated investment companies. Specifically, a REIT is required to distribute only 90 percent, rather than 95 percent, of its income.

Definition of independent contractor

If any class of stock of the REIT or the person being tested as an independent contractor is regularly traded on an established securities market, only persons who

directly or indirectly own 5 percent or more of such class of stock shall be counted in determining whether the 35 percent ownership limitations have been exceeded.

Modification of earnings and profits rules for RICs and REITS

The rule allowing a RIC to make a distribution after a determination that it had failed RIC status, and thus meet the requirement of no non-RIC earnings and profits in subsequent years, is modified to clarify that, when the sole reason for the determination is that the RIC had non-RIC earnings and profits in the initial year (i.e. because it was determined not to have distributed all C corporation earnings and profits), the procedure would apply to permit RIC qualification in the initial year to which such determination applied, in addition to subsequent years.

The RIC earnings and profits rules are also modified to provide an ordering rule similar to the REIT rule, treating a distribution to meet the requirement of no non-RIC earnings and profits as coming first from the earliest earnings and profits accumulated in any year for which the RIC did not qualify as a RIC. In addition, the REIT deficiency dividend rules are modified to take account of this ordering rule.

Provision regarding rental income from certain personal property

The provision modifies the present law rule that permits certain rents from personal property to be treated as real estate rental income if such personal property does not exceed 15 percent of the aggregate of real and personal property. The provision replaces the present law comparison of the adjusted bases of properties with a comparison based on fair market values.

Effective date.--The provision is effective for taxable years beginning after December 31, 2000. The provision with respect to modification of earnings and profits rules is effective for distributions after December 31, 2000.

In the case of the provisions relating to permitted ownership of securities of an issuer, special transition rules apply. The new rules forbidding a REIT to own more than 10 percent of the value of securities of a single issuer do not apply to a REIT with respect to securities held directly or indirectly by such REIT on July 12, 1999, or acquired pursuant to the terms of written binding contract in effect on that date and at all times thereafter until the acquisition.

Also, securities received in a tax-free exchange or reorganization, with respect to or in exchange for such grandfathered securities would be grandfathered. The grandfathering of such securities ceases to apply if the REIT acquires additional securities of that issuer after that date, other than pursuant to a binding contract in effect on that date and at all times thereafter, or in a reorganization with another corporation the securities of which are grandfathered.

This transition also ceases to apply to securities of a corporation as of the first day after July 12, 1999 on which such corporation engages in a substantial new line of business, or acquires any substantial asset, other than pursuant to a binding contract in effect on such date and at all times thereafter, or in a reorganization or transaction in which gain or loss is not recognized by reason of section 1031 or 1033 of the Code. If a corporation makes an election to become a taxable REIT subsidiary, effective before January 1, 2004 and at a time when the REIT's ownership is grandfathered under these rules, the election is treated as a reorganization under section 368(a)(1)(A) of the Code.

The new 10 percent of value limitation for purposes of defining qualified rents is effective for taxable years beginning after December 31, 2000. There is an exception for rents paid under a lease or pursuant to a binding contract in effect on July 12, 1999 and at all times thereafter.

Conference Agreement

The conference agreement includes the provision in S. 1792. The conference agreement clarifies the RIC and REIT earnings and profits ordering rules in the case of a distribution to meet the requirements that there be no non-RIC or non-REIT earnings and profits in any year.

Both the RIC and REIT earnings and profits rules are modified to provide a more specific ordering rule, similar to the present-law REIT rule. The new ordering rule treats a distribution to meet the requirement of no non-RIC or non-REIT earnings and profits as coming, on a first-in, first-out basis, from earnings and profits which, if not distributed, would result in a failure to meet such requirement. Thus, such earnings and profits are deemed distributed first from earnings and profits that would cause such a failure, starting with the earliest RIC or REIT year for which such failure would occur.

2. Modify estimated tax rules for closely held REITs (sec. 6655 of the Code)

Present Law

If a person has a direct interest or a partnership interest in income-producing assets (such as securities generally, or mortgages) that produce income throughout the year, that person's estimated tax payments must reflect the quarterly amounts expected from the asset.

However, a dividend distribution of earnings from a REIT is considered for estimated tax purposes when the dividend is paid. Some corporations have established closely held REITs that hold property (e.g. mortgages) that if held directly by the controlling entity would produce income throughout the year. The REIT may make a single distribution for the year, timed such that it need not be taken into account under the estimated tax rules as early as would be the case if the assets were directly held by the controlling entity. The controlling entity thus defers the payment of estimated taxes.

House Bill

No provision.

Senate Amendment

No provision, but S. 1792, as passed by the Senate, provides that in the case of a REIT that is closely held, any person owning at least 10 percent of the vote or value of the REIT is required to accelerate the recognition of year-end dividends attributable to the closely held REIT, for purposes of such person's estimated tax payments. A closely held REIT is defined as one in which at least 50 percent of the vote or value is owed by five or fewer persons. Attribution rules apply to determine ownership.

No inference is intended regarding the treatment of any transaction prior to the effective date.

Effective date.--The provision is effective for estimated tax payments due on or after November 15, 1999.

Conference Agreement

The conference agreement includes the provision in S. 1792, effective for estimated tax payments due on or after December 15, 1999.