Calendar No. 346

106TH CONGRESS, 1st Session — SENATE — REPORT 106–201

TAX RELIEF EXTENSION ACT OF 1999

OCTOBER 26, 1999.—Ordered to be printed

Mr. ROTH, from the Committee on Finance, submitted the following

REPORT

[To accompany S. 1792]

The Committee on Finance reported an original bill (S. 1792) to amend the Internal Revenue Code of 1986 to extend expiring provisions, to fully allow the nonrefundable personal credits against regular tax liability, and for other purposes, having considered the same, reports favorably thereon and recommends that the bill do pass.

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qualified person in a nonallocation year. The excise tax is 50 percent of the value of the shares on which synthetic equity is based.

Treasury regulations

The Treasury Department is given the authority to prescribe such regulations as may be necessary to carry out the purposes of the provision.

EFFECTIVE DATE

The provision generally is effective with respect to years beginning after December 31, 2000. In the case of an ESOP established after July 14, 1999, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the provision is effective with respect to plan years ending after July 14, 1999.

Q. TREATMENT OF REAL ESTATE INVESTMENT TRUSTS (REITS)

1. Provisions relating to REITs (sec. 221–226, 231, 241, 251, and 261 of the bill and 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 of 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 indebtness 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 or 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 of 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 corporation[37] will be disqualified if, as of the end of its taxable year, it has accumulated earnings and profits from a non-REIT year. A similar rule

[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.

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 specific 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]

REASONS FOR CHANGE

The Committee is concerned that under present law, disqualified income of a REIT may be avoided through transactions with entities that are engaged in activities that produce disqualified income but that are effectively owned by the REIT. For example, a REIT may invest in an entity in which it owns virtually all the value (e.g., through preferred stock) even though it owns only a small amount of the vote. The remainder of the voting power might be held by persons related to the REIT such as its officers, directors, or employees. The REIT might effectively be the beneficiary of virtually all the earnings of the entity, through its preferred stock ownership. Also, the REIT might hold significant debt in the entity, and receive significant interest income that reduces the entity's taxable income (subject to corporate level tax if the entity is a C corporation) while producing permissible income to the REIT.

Similarly, if the entity is a partnership engaged in activities that would generate nonqualified income for the REIT if done directly, the REIT might use a significant debt investment in the partnership combined with a small equity interest, to reduce the amount of nonqualified income it would report from the partnership through its partnership interest, while still receiving a significant income stream through the debt.

As a result of these concerns, the Committee believes that a 10-percent value, as well as a 10-percent vote test, generally is appropriate to test the permitted relationship of a REIT to the entities in which it invests.

The Committee believes, however, that certain types of activities that relate to the REIT's real estate investments should be permitted to be performed under the control of the REIT, through the establishment of a "taxable REIT subsidiary" where there are rules which limit the amount of the subsidiary's income that can be reduced through transactions with the REIT. A limit on the amount of REIT asset value that can be represented by investment in such subsidiaries is also desirable. In addition, the Committee believes it is desirable to obtain information regarding the extent of use of

[38] Treas. Reg. sec. 1.857–11(c).

the new taxable REIT subsidiaries and the amount of corporate Federal income tax that such subsidiaries are paying. One type of activity is the provision of tenant services that the REIT wishes to provide in order to remain competitive that might not be considered customary because they are relatively new or "cutting-edge". The Committee believes that provision of tenant services by taxable REIT subsidiaries will simplify such rental operations since uncertainty whether a particular service provided by a subsidiary is "customary" will not affect the parent's qualification as a REIT. Another type of activity that the Committee believes appropriate for a subsidiary is management and operation of the real estate in which a REIT has developed expertise with respect to its own properties that it also would like to provide to third parties.

The Committee believes that allowing operation of health care facilities directly by a REIT for a limited period of time is appropriate to assure continuous provision of health care services where the facilities are acquired by the REIT upon termination of a lease (as upon foreclosure) where there may not be enough time to obtain a new independent provider of such health care services.

Finally, the Committee believes that a number of other simplifying changes are desirable, including simplifying the determination whether a publicly traded entity is an independent contractor and modifying and conforming certain RIC and REIT distribution rules.

EXPLANATION OF PROVISION

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 issue, in addition to the present law 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 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 may 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 REIT for such activities to fail to be treated as rents from real property. However, rents paid to a REIT are not generally 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 subisdiary 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 Commissioner of Internal Revenue 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 no-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 requirements 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 apply the same earnings and profits ordering rule to such dividends as other REIT dividends.

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 of 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.

2. Modify estimated tax rules for closely held REITs (sec. 271 of the bill and 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 if 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.

REASONS FOR CHANGE

The Committee is concerned that REITs may be used to defer estimated taxes. Income producing property might be acquired in or transferred to a REIT, and a dividend paid from the REIT only at the end of the year. So long as the dividend is paid by year end (or within a certain period after year end), the REIT pays no tax on the dividend, while the shareholder of the REIT does not include the payment in income until the dividend is paid. Thus, the income from the assets is not counted in the earlier quarters of the year, for purposes of the shareholder's estimated tax.

The Committee is concerned that this type of situation is most likely to occur in cases where the REIT is relatively closely held and may be used to structure payments for the benefit of significant shareholders. In such situations, the Committee believes that persons who are significant shareholders in the REIT should be able to obtain sufficient information regarding the quarterly income of the REIT to determine their share of that income for estimated tax purposes.

EXPLANATION OF PROVISION

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 owned 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 16, 1999.

3. Modify treatment of closely held REITs (sec. 281 of the bill and sec. 856 of the Code).

PRESENT LAW

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives pass-through treatment for income that is distributed to shareholders. If an electing entity meets the qualifications 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 tax at the REIT level.

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 organizational structure test, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination. No similar rule applies to corporate ownership of a REIT. Certain transactions have been structured to attempt to achieve special tax benefits for an entity that controls a REIT.

REASONS FOR CHANGE

The Committee is aware of a number of situations in which a closely held REIT may be used as a conduit to recharacterize items of income. Some cases causing concern have already been addressed by legislation (e.g., "liquidating reits," which attempted to eliminate tax on income for a period of years) or by regulations (e.g., "step-down preferred" stock, which attempted to provide a corporate borrower with a deduction for payment of principal as well as interest on a loan).

Despite these actions, the Committee is concerned that closely-held REITs may still be used to obtain other tax benefits, chiefly from the ability to recharacterize the income earned by the REIT as a dividend to the REIT owners, as well as to control the timing of such a dividend. Therefore, the provision adds new ownership restrictions designed to limit opportunities for inappropriate income recharacterization.

In certain limited cases, the Committee believes that additional time to satisfy the new requirements should be granted to enable the REIT to establish an operating history before bringing the REIT public. The Committee believes that, in addition to other indicia, evidence of significant and steady growth of the REIT is an important component in demonstrating an intent to bring the REIT public.

EXPLANATION OF PROVISION

The provision imposes as an additional requirement for REIT qualification that, except for the first taxable year for which an entity elects to be a REIT, no one person can own stock of a REIT possessing 50 percent or more of the combined voting power of all classes of voting stock or 50 percent or more of the total value of shares of all classes of stock of the REIT. For purposes of determining a person's stock ownership, rules similar to attribution rules for REIT independent contractor qualification under present law apply (secs. 856(d)(5) and 856(h)(3)). However, once stock is deemed owned by a qualified entity (a REIT or a partnership of which a REIT is at least a 50 percent partner) it will not be reattributed under section 318(a)(3)(C). The provision does not apply to ownership by a REIT of 50 percent or more of the stock (vote or value) of another REIT.

An exception applies for a limited period to certain "incubator REITs". An incubator REIT is a corporation that elects to be treated as an incubator REIT and that meets all the following other requirements: (1) it has only voting common stock outstanding, (2) not more than 50 percent of the corporation's real estate assets consist of mortgages, (3) from not later than the beginning of the last half of the second taxable year, at least 10 percent of the corporation's capital is provided by lenders or equity investors who are unrelated to the corporation's largest shareholder, (4) the directors of the corporation must adopt a resolution setting forth an intent to engage in a going public transaction, (5) no predecessor entity (including any entity from which the electing incubator REIT acquired assets in a transaction in which gain or loss was not recognized in whole or in part) had elected incubator REIT status, and (6) the corporation must annually increase the value of real estate assets by at least 10 percent.

For purposes of determining whether a corporation has met the requirement that it annually increase the value of its real estate assets by 10 percent, the following rules shall apply. First, values shall be based on cost and properly capitalizable expenditures with no adjustment for depreciation. Second, the test shall be applied by comparing the value of assets at the end of the first taxable year with those at the end of the second taxable year and by similar successive taxable year comparisons during the eligibility period. Third, if a corporation fails the 10 percent comparison test for one taxable year, it may remedy the failure by increasing the value of real estate assets by 25 percent in the following taxable year, provided it meets all the other eligibility period requirements in that following taxable year.

The new ownership requirement does not apply to an electing incubator REIT until the end of the REIT's third taxable year; and can be extended for an additional two taxable years if the REIT so elects. However, a REIT cannot elect the additional two year extension unless the REIT agrees that if it does not engage in a going public transaction by the end of the extended eligibility period, it shall pay Federal income taxes for the two years of the extended period as if it had not made an incubator REIT election and had ceased to qualify as a REIT for those two taxable years. In such case, the corporation shall file appropriate amended returns within 3 months of the close of the extended eligibility period. Interest would be payable, but no substantial underpayment penalties would apply except in cases where there is a finding that incubator REIT status was elected for a principal purpose other than as part of a reasonable plan to engage in a going public transaction. Notification of shareholders and any other person whose tax position would reasonably be expected to be affected is also required.

If an electing incubator REIT does not elect to extend its initial 2-year extended eligibility period and has not engaged in a going public transaction by the end of such period, it must satisfy the new control requirements as of the beginning of its fourth taxable year (i.e., immediately after the close of the last taxable year of the two-year initial extension period) or it will be required to notify its shareholders and other persons that may be affected by its tax status, and pay Federal income tax as a corporation that has ceased to qualify as a REIT at that time.

If the Secretary of the Treasury determines that an incubator REIT election was filed for a principal purpose other than as part of a reasonable plan to undertake a going public transaction, an excise tax of $20,000 is imposed on each of the corporation's directors for each taxable year for which the election was in effect.

A going public transaction is defined as either (1) a public offering of shares of stock of the incubator REIT, (2) a transaction, or series of transactions, that result in the incubator REIT stock being regularly traded on an established securities market (as defined in section 897) and being held by shareholders unrelated to persons who held such stock before it began to be so regularly traded, or (3) any transaction resulting in ownership of the REIT by 200 or more persons (excluding the largest single shareholder) who in the aggregate own least 50 percent of the stock of the REIT. Attribution rules apply in determining ownership of stock. The requirement that an incubator REIT have only common stock outstanding shall not fail to be met for a taxable year merely because during that year a going public transaction is accomplished through a transaction described in section 368(a)(1), with another entity that had another class of stock outstanding prior to the transaction.

EFFECTIVE DATE

The provision is effective for taxable years ending after July 14, 1999. Any entity that elects (or has elected) REIT status for a taxable year including July 14, 1999, and which is both a controlled entity and has significant business assets or activities on such date, will not be subject to the proposal. Under this rule, a controlled entity with significant business assets or activities on July 14, 1999, can be grandfathered even if it makes its first REIT election after that date with its return for the taxable year including that date.

For purposes of the transition rules, the significant business assets or activities in place on July 14, 1999, must be real estate assets and activities of a type that would be qualified real estate assets under section 856 of the Code and would produce qualified real estate related income for a REIT.