Tax Report #957

New York State Bar Association

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July 8, 1999

The Hon. Jonathan Talisman
Deputy Assistant Secretary, Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Talisman:

Enclosed is a report of the New York State Bar Association, Tax Section, discussing proposals in the Administration's Fiscal Year 2000 Budget, as well as similar proposals contained in HR 1616, which was introduced on April 28, 1999. These two proposals seek to change the manner in which an REIT may own an interest in a taxable, non-REIT subsidiary, and, as a separate matter, address concerns with aggressive tax shelter transactions which utilize "closely-held" REITs as an element of the transaction.

The first portion of our report comments on the taxable subsidiary proposals and makes a number of specific technical recommendations. But our overall comment is our belief that any

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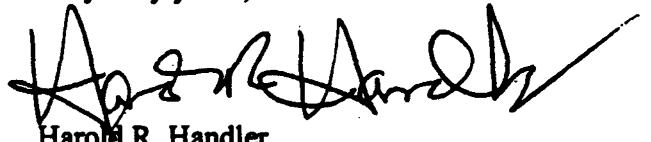
significant changes in the rules governing REITs should be in the direction of greater simplicity and certainty of REIT status, addressing perceived abuses by imposition of penalties or other "intermediate sanctions" rather than threat of loss of REIT status.

As to the concerns with respect to "closely-held" REITs, and consistent with our general view that corporate tax shelter transactions need to be addressed, the majority of our Executive Committee supports the proposal to exclude from REIT treatment any corporation more than 50% of the stock of which is owned by a single shareholder. A significant minority, however, believes that these perceived abusive transactions should be dealt with more directly, rather than limiting the types of corporations eligible to be taxed as REITs. We also have a consensus that if this limitation on REIT status is adopted, modifications should be adopted to assure that this limitation does not apply too broadly.

We would be pleased to discuss the report with you at your convenience.

Very truly yours,



Harold R. Handler
Chair

Enclosure

cc: Joseph M. Mikrut, Esq.

NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON LEGISLATIVE PROPOSALS RELATING TO REITs

I. REIT Taxable Subsidiaries

This portion of our report[1] addresses two proposals to change the manner in which a REIT may own an interest in a taxable, non-REIT subsidiary. The first proposal is that put forth by the Administration in its year 2000 budget proposals. The second is H.R. 1616, introduced by members of the House Ways & Means Committee on April 28, 1999.[2] The two proposals are similar and in many respects appear to be identical. Because the text of H.R. 1616 is available, it offers more detail than the Administration's proposal. The bill, moreover, incorporates several provisions applicable to REITs that go beyond what is included in the Administration's proposal, upon which we are not commenting here.

A. Issues Addressed – Current Law

Current law contains limitations on the amount of securities, other than government securities or securities that are treated as real estate assets, that a REIT may own. Overall, not more than 25% of the value of a REIT's assets can consist of such securities. Not more than 5% of the value of the REIT's assets may consist of the

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1 This report was prepared by the Tax Section's Committees on Pass-Through Entities and Real Property. The principal authors of this report are Janet B. Korins, Victoria J. Litz and Kimberly S. Blanchard. Helpful comments were received from William B. Brannan, Thomas A. Humphreys, Morris Kramer, Marc L. Silberberg, Alan J. Tarr and Lary S. Wolf.

2 A companion bill, S.1057, was introduced in the Senate on May 14, 1999.

securities of any one issuer (the "5% Test"). Finally, a REIT may not own more than 10% of the voting securities of any one issuer (the "10% Test").[3]

REITs are also subject to gross income tests that limit the types of income they can earn. At least 95% of a REIT's gross income must consist of dividends, interest, rents from real property and certain other specified items. At least 75% of its gross income must consist of rents from real property, mortgage interest and other items, excluding dividends. Section 856(d)(1)(B) of the Code includes as rents from real property a REIT's income from "customary" services rendered in connection with the rental of real property. REITs may also provide tenant services that could be provided by a tax-exempt entity within the rubric of Code section 512(b)(3); however, these services are also generally limited to services customarily provided to tenants. For all other tenant services, a REIT is generally required to retain an independent contractor from whom the REIT derives no income.[4] An independent contractor, as defined by Section 856(d)(3), cannot own more than 35% of the REIT's shares, and persons owning 35% or more of the REIT's shares, directly or indirectly, cannot control 35% or more of the interests (by vote or by number) in the independent contractor.

These restrictions were designed to prevent REITs from controlling or participating in the income from so-called "tenant convenience" services, as well as from engaging in nontenant-related management or development activities. However, despite

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3 Section 856(c)(4)(B) of the Code.

4 Code §§856(d)(2), (d)(7).

these limitations, under current law REITs have used taxable subsidiaries to engage in activities that a REIT cannot engage in directly. One of the most common ways these limitations are dealt with is by use of a "preferred stock subsidiary" in which the REIT owns 10% or less of the voting stock, but all or most of the nonvoting stock. Usually, the balance of the subsidiary's voting stock is held by the REIT's employees, directors or affiliates; for purposes of the 10% Test, attribution of ownership rules do not apply.

Through its ownership of nonvoting stock, the REIT obtains substantially all of the economic benefit of the subsidiary's income. It can also convert into net dividend income, qualifying under the 95% gross income test, what would be nonqualifying gross income if earned directly. Moreover, the subsidiary can be capitalized with debt by the REIT, the interest on which reduces the subsidiary's taxable income and can be received by the REIT as gross income qualifying under the 95% gross income test.

B. The Proposals

Both the Administration's proposal and H.R. 1616 attempt to respond to two concerns under current law. The first concern, quite clearly reflected in the proposals, is that the income of a taxable subsidiary may be inappropriately deflected to the REIT, which generally is not subject to tax. A second concern appears to be that REITs are inappropriately avoiding the restrictions designed to limit the scope of their activities through the use of subsidiaries that literally fall within the 10% Test, but that provide the REIT with the economic benefits of such activities through the use of nonvoting stock and even "de facto" voting control where individuals affiliated with the

REIT own a majority of the subsidiary's voting stock.

At the same time, both proposals recognize that current law may be overly restrictive, and that so long as taxable REIT subsidiaries pay corporate-level tax on their true economic income, REITs should be permitted to engage in certain specified, nontraditional activities indirectly through ownership of taxable subsidiaries.

Both proposals would change the 10% Test, which is currently based on the ownership of more than 10% of the voting securities of a subsidiary, to a test that would be based on the REIT's ownership of more than 10% of the vote *or value* of a subsidiary's securities. This change would significantly reduce a REIT's ability to capture the economics inherent in a taxable subsidiary. However, both proposals would give back a large part of what is thus taken away by exempting from the new 10% Test, as well as from the 5% Test, any stock in a "qualified" subsidiary.[5] Under the proposals, a REIT could own up to 100% of the stock of a qualified subsidiary.

The proposals conceive of qualified subsidiaries similarly, although the Administration's proposal distinguishes definitionally between two types of qualified subsidiaries: a "qualified business subsidiary" and a "qualified independent contractor subsidiary." Using the terminology of the Administration's proposal, a qualified business subsidiary could provide services such as management or development services to third parties (nontenants); a qualified independent contractor subsidiary, like a current-law independent contractor, could provide services to tenants of REIT properties that go

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5 H.R. 1616 uses the term "taxable REIT subsidiary," but because the type of subsidiary being referred to is virtually identical to that described in the Administration's proposals, the term "qualified subsidiary" will be used herein.

beyond those customary services that a REIT can provide. However, the Administration proposal does not contain a comprehensive definition of either type of qualified subsidiary. Any comprehensive definition to be included in future legislative language might raise additional issues not addressed herein.

H.R. 1616 would create a single class of qualified subsidiaries, the status of which would be elective. Unlike the Administration's proposal, the bill would deem certain business activities to be impermissible, specifically prohibiting a qualified subsidiary from engaging in the operation or management of hotel and health care facilities, subject to a limited exception where a noncasino hotel is operated by an independent contractor on behalf of a qualified subsidiary.

The Administration's proposal would impose new limitations on the total amount of REIT assets that the value of qualified subsidiary stock may represent: the value of all qualified independent contractor subsidiaries could not exceed 5% of the value of the REIT's assets, and the value of all qualified subsidiaries could not exceed 15% of the value of the REIT's assets. In contrast, H.R. 1616 would leave unchanged the current restriction under which not more than 25% of a REIT's assets can consist of securities, with the effect that stock of qualified subsidiaries would remain subject to the existing 25% cap.

Both proposals contain new provisions aimed at curbing the ability of a qualified subsidiary inappropriately to shift income to a related REIT. Both would impose a 100% excise tax on certain deductible payments made by a qualified subsidiary to the REIT that have the effect of leaving the qualified subsidiary with less than an

arms'-length profit on the services it provides to tenants or others. While H.R. 1616 contains specific rent-stripping rules measured by reference to section 482 principles, the Administration proposal vaguely speaks of placing "significant limits" on intercompany rents.

Both proposals contemplate the adoption of an interest-stripping rule that would reduce or eliminate any deductions for related-party interest paid by qualified subsidiaries. H.R. 1616 specifically extends the section 163(j)(3) definition of disqualified interest to interest paid by a qualified subsidiary to a REIT. It would also impose the excise tax on interest paid if the rate of interest is in excess of a "commercially reasonable" rate. The Administration proposal speaks of disallowing interest paid by a qualified subsidiary to the extent the interest is "directly or indirectly funded" by the REIT.

Both proposals would become effective upon enactment. The Administration's proposal contemplates transition rules to permit REITs to combine and convert existing preferred stock subsidiaries into one or more qualified subsidiaries on a tax-free basis. H.R. 1616 would, in addition, grandfather taxable subsidiaries existing on April 28, 1999, with loss of grandfather status where the subsidiary acquires a new business or substantial new assets.

C. Recommendations

1. In General.

In general, the proposals (as well as the current-law restrictions they address) represent political compromises concerning the extent to which REITs should be

permitted to hold interests in taxable entities that engage in activities traditionally prohibited to REITs. For this reason, the proposals generally do not present tax policy issues that it would be useful for us to comment upon. However, as a general proposition we believe that any significant changes in the rules governing REITs should move the law in the direction of greater simplicity and certainty of REIT status, addressing perceived abuses of the REIT rules by the imposition of penalties or other "intermediate sanctions" rather than by the threat of loss of REIT status. In other areas of the law, the determination of an entity's status has been simplified (e.g., under the "check-the-box" regulations) and loss-of-status threats curtailed (e.g., under the intermediate sanctions regime of section 4958 of the Code, and in the S corporation area). Because REITs represent a significant and growing portion of the public equity markets, we believe that certainty and relative simplicity in the application of statutory tests relating to a REIT's status should be a principal objective of any legislation that clarifies the scope of a REIT's permitted investments.

2. Distinctions Between and Percentage Limitations on Qualified Subsidiaries.

We see no need to distinguish between two different types of qualified subsidiaries. In particular, we see no compelling reason why one subsidiary could not act as an "independent contractor" providing services to tenants and also act as a "business subsidiary" providing services to nontenants. We believe that REITs will want and need to operate nonqualified businesses through a single subsidiary providing services to tenants and, where appropriate, third parties. Particularly where tenant and nontenant services overlap, it would be cumbersome to require the use of two separate subsidiaries.

We therefore favor the approach of H.R. 1616, which would make no distinction between different types of qualified subsidiaries.

Classification as a qualified subsidiary would be elective under H.R. 1616. We support this approach, but note that it may not work if coupled with the Administration's proposal to place separate 5% and 15% limits on the value of different types of qualified subsidiary stock that a REIT may own.

We believe that the Administration's proposed new 5% and 15% limits upon the percentage of REIT assets that may consist of securities in qualified subsidiaries unnecessarily complicate an already highly technical set of restrictions. While we appreciate that any decision as to the extent REITs may engage, indirectly, in activities currently prohibited to them is ultimately a political decision, we believe that adding new and more restrictive limitations upon the percentage of a REIT's value that may consist of securities exacerbates valuation and disqualification issues that already exist in this context. Increases in the value of qualified subsidiaries (however such value is determined) could trigger the REIT's disqualification as a REIT. To comply with these new limitations, absent a grandfathering rule a REIT may be forced to sell securities it currently owns. The potential tax and nontax consequences of such sales are not addressed by the contemplated transition relief.

In lieu of imposing new percentage requirements, we would recommend that the approach of H.R. 1616 be adopted and even strengthened by limiting the types of businesses in which a qualified subsidiary could engage. For example, legislation could require that a qualified subsidiary's nontenant related activities be limited to activities

that are an extension of, or integrally related to, the REIT's real estate portfolio.

3. Interest-Stripping and Other Deductible Payments.

We are uncertain about the scope of the Administration's proposed disallowance of a subsidiary's deduction for interest on debt "directly or indirectly funded" by a REIT. The Joint Committee description of this proposal instead speaks of "interest paid directly or indirectly to the REIT." The former language suggests that if a REIT guarantees or otherwise provides credit support for a subsidiary's third-party debt, interest on such debt would be disallowed. The latter formulation instead appears to import a conduit concept. In either case, tracing may be difficult to administer absent detailed guidance. We would therefore suggest simply that the rule of section 163(j) be adopted (as proposed in H.R. 1616) and that the implementation of section 163(j) be left to regulations.

We assume that the imposition of an excise tax on excessive interest paid by a qualified subsidiary to a REIT would apply only where the deduction of such interest is not disallowed by the interest-stripping rule (for example, because the subsidiary's debt-to-equity ratio is less than 1.5 to 1), and this point should be clarified in any legislation. We would also suggest that in lieu of the "commercially reasonable" test used to determine the amount of excess interest under H.R. 1616, the determination of whether the interest rate is excessive should be based on a spread over the AFR, in a manner similar to current section 163(i).

H.R. 1616 contains fairly specific rules that could have the effect of imposing an excise tax on other types of income-stripping payments such as excessive

rent. The Administration's proposal refers generally to limits that would be placed on intercompany rents. We believe that, in lieu of H.R. 1616's excise tax proposal, a more general disallowance of deductions for certain excessive and deductible payments by a qualified subsidiary to a REIT should be considered.

4. New Excise Taxes

The proposed new 100% excise tax on excess payments may represent some frustration on the part of the Administration and Congress that current section 482, and the attendant threat of reallocation and penalties, is incapable of being adequately policed. The Administration's proposal is unclear as to whether the proposed standards would be identical to the standards developed under section 482. Under H.R. 1616, the new excise tax would be imposed in lieu of, and not in addition to, a section 482 reallocation, but section 482 principles would apply. Thus, H.R. 1616 does not change the basic test for what is "excessive," or other than at arm's-length.

H.R. 1616 carves out five "safe harbors" to which the new excise tax would not apply. It is unclear whether these safe harbors merely restate Congress's understanding of the limits of section 482, or whether a real difference in the standards to be applied was intended. Because most of the safe harbors appear indistinguishable from the basic arm's-length principle of section 482, we wonder whether the new proposals represent much more than a restatement of current law coupled with the imposition of a new penalty regime. In any event, we question whether the government's inability to police longstanding and well-recognized arm's-length principles should form the basis for a new and particularly draconian penalty.

5. Treatment of Amounts Paid by a Qualified Subsidiary to the REIT

H.R. 1616 helpfully makes clear that, with certain limitations, rents paid by a qualified subsidiary to a related REIT will qualify in the REIT's hands as "rents from real property" by amending section 856(d)(2)(B) of the Code (which generally excludes from "rent" amounts received from 10% or greater subsidiaries). Presumably, any dividends and interest paid by a qualified subsidiary to a REIT will qualify in full as dividends and interest under the 95% gross income test.

6. Effective Date.

Finally, we are in favor a fairly liberal grandfathering rule from the 10% Test, such as that proposed in H.R. 1616. The proposals to allow REITs to own up to 100% of qualified subsidiaries, up to certain limits, appear to reflect a consensus that the current use of "preferred stock" subsidiaries is not inherently suspect. Absent adequate grandfathering relief, REITs could incur significant tax and other expenses in realigning their interests in existing subsidiaries to fit the new model, and it is not clear to us that much would be gained thereby. H.R. 1616 adequately guards against abuse of the grandfathering rule by providing for loss of protection where an existing taxable subsidiary acquires a significant new business or assets.

II. Closely-Held REITs

This portion of our report addresses the Administration's proposal to exclude from REIT status any corporation, 50% or more of the stock of which (by vote or by value) is owned, directly or indirectly, by a single shareholder (other than another REIT). The proposal generally would be effective for entities electing REIT status for

taxable years beginning on or after the date of the first committee action, but would also apply to an existing REIT if such REIT did not have significant business assets or activities as of such date.

A. Issues Addressed – Current Law

A REIT is required to have at least 100 shareholders during at least 335 days of each full taxable year after its first taxable year as a REIT. No more than 50% of the value of the outstanding stock of a REIT may be owned, directly or indirectly, actually or constructively, by or for five or fewer individuals at any time during the last half of any taxable year after the first year that such corporation otherwise qualifies as a REIT (the "5/50 Test").

Even after applying these rules, it is possible for a REIT to be closely held. For example, a corporation could own 99.9% of the stock of a REIT with 99 of its employees owning the remaining 0.1%. Assuming that the corporate shareholder did not run afoul of the 5/50 Test, then the REIT itself would also meet this test. The 100 shareholder test would have been met through the use of the employee shareholders.

The Administration's stated concern is that closely-held REITs are being used improperly in connection with tax-motivated transactions. For example, in 1997 the Service targeted the use of "step-down" preferred stock, transactions in which REITs were typically involved, to shift income from taxable investors to tax-indifferent parties in the early years after the issuance of such stock.[6] As another example, in 1998 Congress acted to curtail the use of liquidating REIT structures by C corporations to

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6 Notice 97-21, 1997-11 I.R.B. 9; Prop. Reg. §1.7701(1)-3.

remove earnings from an 80%-owned REIT without taxation at the REIT or parent level.

It is unclear whether the proposal also reflects a more general policy view that "private REITs" should not exist. We believe that this is an issue separate and distinct from the use of REITs in transactions perceived to be abusive.

B. Recommendations

1. In general

The Committee was divided over the basic issue of whether abuses unrelated to the specific operation of the REIT rules, e.g., "step-down preferred stock," should be targeted by restricting the class of corporations eligible to elect REIT status. A majority of the Committee believes that there is no compelling reason to permit the use of private or captive REITs, and that it is too easy to set up a private REIT simply for the purpose of entering into such transactions. These members assume that widely-held REITs, whether or not their shares are publicly traded, would generally not agree to participate in such transactions. These members also believe that the original purpose of the 100-shareholder rule and the 5/50 Test may well have been to limit the use of REITs to publicly-traded or at least widely-held entities. Consequently, the majority supports the Administration Proposal to exclude from REIT treatment any corporation more that 50% of the stock of which is owned by a single shareholder, subject to the comments expressed below.

A significant minority of the Committee believes that it is inappropriate to target perceived abuses such as step-down preferred stock indirectly, by limiting the types of corporations eligible to be taxed as REITs. They point out that many of the abusive

transactions depend not so much on the REIT's status as such, but on the participation of a tax-indifferent party who can absorb dividend income on a tax-free basis, and on the interplay of Code provisions (e.g., section 301) having nothing to do with REITs. These members also believe that private REITs are unobjectionable, since many of the benefits of REIT status are not substantially different from what could be accomplished, more simply, using limited liability companies taxable as partnerships. Moreover, the 100-shareholder rule and the 5/50 Test no longer apply to RICs or generally to REMICs.

Those who object to the Administration's proposal also fear that its adoption could have unanticipated and unintended adverse consequences in nonabusive cases. For example, if an entity operating as a publicly-traded REIT is acquired or otherwise taken private, under the Administration's proposal the REIT would lose its REIT status and become taxable as a C corporation. In such cases, the REIT could not be converted into a tax-transparent LLC or partnership without triggering a corporate-level tax. This does not appear to these members to be an appropriate result, at least in this era where limited liability can co-exist with tax transparency.

Most members of the Committee, regardless of their views on the basic merits of the proposal, are concerned that the proposal may extend too broadly. At a minimum, we would recommend that the Administration modify its proposal to exclude from its scope publicly-traded REITs and "incubator REITs" which are typically formed by a sponsor for the purpose of establishing a track record in anticipation of a public offering of the REIT's shares The exception for publicly-traded REITs would apply to REITs that have a class of stock regularly traded on an established securities market. In

our experience, it is not uncommon that a bona fide public REIT might have one 50% or greater shareholder.

In addition, we propose that a REIT be permitted to elect "incubator REIT" status. Generally, the majority of stock in an incubator REIT is held by the sponsor, with a limited number of outside investors holding the remaining stock. A REIT that has elected incubator REIT status would generally be required to qualify as a publicly-traded REIT, or to become widely-held, within some prescribed time period (e.g., four years) after its formation. If the incubator REIT did not timely become publicly-traded or widely-held, then the incubator REIT could be treated as other than a REIT on a prospective basis.

2. When Test Should be Applied

Currently the 100 shareholder requirement and the 5/50 Test do not apply to a REIT's initial taxable year. In addition, the 5/50 Test applies only in the last half of all later taxable years. We recommend that parallel rules be adopted it the new closely-held test is enacted.

2. Definition of "Closely-Held".

To the extent that the proposal is designed to address abuses at least partially related to the REIT rules, such as the former use of liquidating REITs, consideration should be given to disqualifying from REIT status only those entities in which 80% or more of the stock is held by a single shareholder. The adoption of an 80% test, rather than the proposed 50% test, would likely curtail the worst abuses without penalizing bona fide REITs (including any publicly-traded REIT with a significant, but

less than 80%, shareholder).

The Administration's proposal applies to any person who holds shares in a REIT. It may be appropriate to modify the proposal to include look-through rules for pass-through entities and pension trusts that own shares in a REIT. The REIT provisions were only recently amended to adopt such a look-through rule for pension trusts for purposes of the 5/50 Test.[7]

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7 Section 856(h)(3) of the Code.