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Chairman Camp's Proposals Place REITs in the Crosshairs

On February 25, House Ways and Means Committee Chairman David Camp (R.-Mich.) proposed a dramatic overhaul of the U.S. tax code (the Code). While the "Tax Reform Act of 2014," (the Proposals) contains a number of previously released tax law changes, it also includes an unexpected and unwelcome strike on many public REITs. The general consensus is that the Proposals are unlikely to reach a vote in the House in 2014. It has been nearly 30 years since Congress last seriously considered tax reform, and Speaker John Boehner (R.-Ohio) has stated that the release of the Proposals is just the beginning of a "public conversation on tax reform." Boehner also has denied that the Proposals represent the official platform of the Republican Party. Senate Minority Leader Mitch McConnell (R.-Ky.) has said that there is "no hope" for tax reform being accomplished this year. The immediate impact of the Proposals is likely to be minimal, other than increasing anxiety among REIT managers and investors and creating a need for greater disclosure.

If enacted, however, the proposals would prove highly disruptive, not only effectively preventing companies from converting to REITs, but also substantially precluding their acquisition by existing REITs, thus harming shareholders of both REITs and non-REITs.

Of the many provisions targeting REITs, those most likely to have a significant impact to the industry include:

Immediate taxation on built-in gains upon REIT election

Under current law, a REIT that previously operated as a C-corporation is subject to taxation on certain built-in gains inherent in property held during its C-corporation years if the gain is recognized within 10 years after the REIT election. The Proposals would impose this tax on all built-in gains immediately at the time of the REIT election, even though the REIT still holds the properties. This provision not only ignores the administrative burden of calculating the amount of such gains, but more importantly, also curtails the ability of any existing real property company, even those that own office or apartment buildings, from electing REIT status by imposing a potentially devastating upfront toll charge on REIT elections. REITs like Ventas Inc. or Rouse Properties Inc. would never have existed if this provision had been the law.

Moreover, the provision contains an immediate effective date for "elections after February 26, 2014." It is not clear whether a REIT that began its REIT status on January 1, 2014, but doesn't actually make the "election" until 2015, would be subject to this rule. Immediate effective dates in tax reform legislation generally are reserved for provisions meant to disallow abusive tax shelters, which is not the case in REIT conversions.

Prevention of tax-free spinoffs involving REITs

The Proposals would provide that REITs could not satisfy the active trade or business requirement for tax-free spinoffs. Furthermore, neither a distributing corporation nor a controlled corporation would be allowed to elect REIT status for 10 years following a tax-free spinoff.

This provision also has an immediate effective date of February 26, 2014.

Non-REIT earnings and profits must be distributed in cash

Under current law, entities that elect REIT status are required to distribute any earnings and profits accumulated during non-REIT years by the end of their first REIT year. REITs often make these distributions in a combination of cash and stock. Under the Proposals, REITs would be required to distribute non-REIT earnings and profits solely in cash.

This provision, along with the proposed reform requiring immediate taxation on built-in gains upon a REIT conversion of a C-corporation, will make it impractical for existing companies to convert to REITs or for existing REITs to acquire non-REIT corporations. It is important to note that this provision raises virtually no additional revenue, because both the stock and cash portions of such dividends are fully taxable.

Limitations on the definition of “real property”

The Code requires that at least 75 percent of a REIT’s assets consist of real estate assets, cash and cash items, and at least 75 percent of a REIT’s income be derived from real estate-related sources. Under the Proposals, “real property” would be defined to exclude timber as well as all tangible property with a class life of less than 27.5 years (as defined under the depreciation rules) for purposes of the REIT income and asset tests. This provision would exclude not only timber, but also cell towers, billboards and several other real estate asset classes in which many public REITs are invested today, in many cases comprising their entire portfolios.

The provision removing timber from the definition of “real property” is particularly surprising, because the IRS first confirmed that timber companies can be REIT-qualifying in the early 1970s, and subsequent use of the REIT structure led to a revitalization of the timber industry. The provision applies beginning in 2017 and creates uncertainty for these companies.

Reduction in the percentage of REIT assets that may be taxable REIT subsidiaries

Current law permits securities of taxable REIT subsidiaries to constitute up to 25 percent of the value of a REIT’s assets. The Proposals would reduce this 25 percent limitation to 20 percent, making it more difficult for REITs to operate the non-real estate portions of their businesses in fully-taxable corporations.

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Given the existing situation in Washington, it is difficult to predict whether any of these Proposals are likely to be adopted in anything resembling their current form in the near future. The Proposals nevertheless illustrate that certain corners of the REIT universe are perceived as a source of potential revenue to be harvested. We will continue to monitor these developments closely.