State of California

Franchise Tax Board-Legislative Services Bureau
PO Box 1468
Sacramento, CA 95812-1468

Telephone: (916)845-4326
ATSS: 468-4326
FAX: (916)845-5472

Legislative Change No. 01-02

Bill Number: AB 10 Author: Corbett Chapter Number: 01-04

Laws Affecting Franchise Tax Board:

Date Filed with the Secretary of the State: March 29, 2001

SUBJECT: Real Estate Investment Trust (REIT) Conformity

Assembly Bill 10 (Corbett), as enacted on March 29, 2001, made the following changes to California law:

Section 19147 of the Revenue and Taxation Code is amended.

The Act conforms to the new federal rule that accelerates the recognition of year-end dividends attributable to the closely held REIT for estimated tax purposes under the B&CTL. These estimated tax changes are made effective for estimated tax payments due on or after January 1, 2001.

The above applies to a closely held REIT. Any person subject to the corporate estimated tax rules owning at least 10% 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 due on or after January 1, 2001.

A closely held REIT is defined as one in which at least 50% of the vote or value is owned by five or fewer persons. Attribution rules apply to determine ownership.

Section 24872 of the Revenue and Taxation Code is amended.

The Act conforms to the new federal REIT qualification provisions enacted by The Ticket to Work Act of 1999, except that no excise tax would be imposed. The effective date will be the same for California as it is for federal purposes (i.e., for taxable years beginning after December 31, 2000). The provision with respect to modification of the earnings and profits rules would be effective for distributions after December 31, 2000, the same date as under federal law. California also would conform to the federal transition rules.

The Ticket to Work Act of 1999 made the following changes:

Bureau Director	Date
Brian Putler	05/25/01

A. Investment limitations and taxable REIT subsidiaries

Under the provision, a REIT generally cannot own more than 10% 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% of the outstanding voting securities of a single issuer.

In addition, no more than 20% of the value of a REIT's assets can be represented by securities of the taxable REIT subsidiaries that are permitted under the Act.

Exception for safe-harbor debt

For purposes of the new 10% value test, securities are generally defined to exclude safe harbor debt owned by a REIT (as defined for purposes of IRC 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% or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20% 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 IRC Sec. 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% 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% 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 Act, 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% 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% 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 health care 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 IRC Sec. 163(j). Thus the taxable REIT subsidiary cannot deduct interest in any year that would exceed 50% 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% 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% 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.

B. 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 two-year period can be granted.

C. 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%, rather than 95%, of its income.

D. 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% or more of such class of stock shall be counted in determining whether the 35% ownership limitations have been exceeded.

E. 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 Act 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 that, 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.

F. 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% 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.

G. Federal effective date and transition rules

The provision is effective for federal purposes 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% 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 rule 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 IRC Sec. 1031 or 1033. 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 IRC Sec. 368(a)(1)(A).

The new 10% 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.

Section 24872.6 is added to the Revenue and Taxation Code.

The Act makes qualification as a California REIT dependent upon qualification as a federal REIT for the taxable year with no separate state election allowed, and makes a qualified federal REIT a qualified state REIT for the same taxable year

This Act is effective January 1, 2001.

This Act will not require any reports by the department to the Legislature.