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Ticket to Work and Work Incentives Act of 1999

By: Elliot Pisem and Ezra Dyckman

On December 17, President Clinton signed the Ticket to Work and Work Incentives Improvement Act of 1999. As is indicated by its upbeat title, the Act does create a new employment incentive program. However, the Act also contains a variety of substantive changes to the Internal Revenue Code. Two areas that are likely to be of concern to corporate taxpayers—particularly, but far from exclusively, those in the real estate industry—are changes to the rules governing installment sales and a rewriting of many of the tax rules governing real estate investment trusts ("REIT's").

Installment Sales

The installment sale provisions of the Code allow a seller to defer the imposition of tax on a sale of assets until payments are actually received. This provision is frequently used in sales of real estate and sales of small businesses, in both of which seller financing is common. Under the Act, installment sale treatment will be denied to taxpayers whose overall method of accounting is the accrual method, effective for sales on and after the date the President signs the Act.[1]

Even prior to the Act, there have been a number of significant limitations on use of the installment method. For example, the installment method may not be used to report gain on the sale of personal property of a kind which is required to be included in the taxpayer's inventory if on hand at the close of the taxable year, of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business (subject to a limited exception for certain timeshares and residential lots), or of stock or securities which are traded on an established securities market, nor may it be used to report income from "depreciation recapture."[2] Moreover, even when use of the installment method is available, the seller may be subject to an "interest charge" on a portion of the tax liability that is being deferred by the use of that method; this interest charge, however, generally applies only if the face amount of all installment obligations held by a taxpayer that arose during a particular year and are outstanding at the close of such year exceeds $5,000,000.[3]

The Act will prohibit any taxpayer that uses the accrual method of accounting from reporting *any* gains on the installment method.[4] The Internal Revenue Code and Treasury Regulations generally require use of the accrual method by (1) any C corporation the average annual gross receipts of which exceed $5,000,000 (except for certain personal service (health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting) corporations and certain farming businesses) and (2) any other business, regardless of its size, in which it is necessary to use an inventory.[5] Thus, such taxpayers, as well as any other taxpayer that uses the accrual method of accounting, will now be prohibited from using the installment method for *any* sale of property.

Since virtually all individuals are cash method taxpayers with respect to their investment activities, this amendment does not affect installment sale treatment for sales by individuals of investment assets. For example, one of the committee reports accompanying the Act indicates that the amendment does not affect individual taxpayers who are the owners of interests in an accrual method entity upon the sale of their interests in such entity.[6] Therefore, where feasible, installment sale treatment can be obtained by converting an entity-level sale of assets into a sale of interests in the entity (sale of partnership interests or corporate stock).

The denial of the use of the installment method to accrual basis taxpayers will have effects beyond those situations in which transactions are intentionally structured as installment sales. For example, the amendment will also affect "failed" like-kind exchanges intended to be tax-free under Internal Revenue Code section 1031. In the context of a "deferred" tax-free exchange, section 1031 requires that the taxpayer "identify" replacement property within 45 days after transferring the relinquished property and receive the replacement property before the earlier of (i) 180 days after the transfer of the relinquished property and (ii) the due date of the taxpayer's return for the year of the transfer. If it eventuates that the taxpayer is unable either to identify or to acquire an appropriate replacement property within the required time periods, the taxpayer may then receive the cash proceeds of the disposition. Treasury Regulations under section 1031 have provided that such a "failed" section 1031 exchange may generally be treated as an installment sale, so that, if cash proceeds are received in a taxable year after the year in which the taxpayer disposes of the relinquished property, the gain may be reported in the later year.[7] Under the Act, however, if the taxpayer uses the accrual method as its overall method of accounting, the taxable income from a "failed" exchange would be recognized in the year of disposition.

There are other circumstances in which the installment method has served as a "fall back" to the possible inapplicability of provisions that would make a transaction wholly tax-free (albeit at the potential cost of the imposition of an "interest charge"). An example of such a situation is a modification of particular terms of a debt instrument held by the taxpayer. The taxpayer may take the position that such a modification is not a "significant modification" and thus is not a taxable event.[8] If it is later determined that the modification was significant, installment sale treatment might be available to protect the taxpayer from being required to recognize "noncash" income in the year of the modification. This potential fall back position will no longer be available to accrual basis taxpayers.[9]

Real Estate Investment Trusts

The REIT amendments of the Act, which were sponsored and initially drafted by the National Association of Real Estate Investment Trusts, take a large step toward freeing REIT's from restrictions which have long prevented them from operating their real estate in a manner similar to non-REIT landlords. These changes, which are generally effective as of January 1, 2001, represent an ongoing effort by Congress to update the REIT provisions in a way that enables REIT's to compete effectively with other owners of real estate, in terms both of generating income and of attracting tenants by providing comparable services.

REIT's are subject to two "gross income" tests. These tests require that a certain percentage of a REIT's gross income be derived from certain sources. Failure to comply with these tests can result in disqualification as a REIT. The first test requires that at least 75% of the REIT's gross income must be derived from rents from real property, interest from real property mortgages, gain from the sale of real property, and other specified real estate-related sources (the "75% test"). The other test requires that 95% of a REIT's gross income come from these sources or from dividends, interest, or capital gains from the sale of securities (the "95% test").[10] For many REIT's, the 95% test is the more formidable obstacle, since it leaves room for only 5% of a REIT's gross income to be from nonqualifying sources (commonly referred to as "bad income"). One important exception to the rule that rents from real property qualify under the 75% and 95% tests involves situations in which the REIT or certain affiliated entities perform "noncustomary services" for a tenant of the REIT's properties. In such cases, the rent from that tenant—and, possibly, all rent from the entire building in which that tenant's space is located—may be bad income.

The obvious way to avoid the REIT income limitations would seem to be for a REIT to conduct its nonqualifying activities through corporate subsidiaries (which would themselves be taxable, but the dividends from which would qualify under the 95% test). Unfortunately, the REIT rules also contain "asset tests," under which a REIT may not own 10% of the outstanding voting securities of any other corporation. Thus, REIT's have taken to conducting various activities through "preferred stock subsidiaries," corporations in which the REIT owns the lion's-share of the economics (through debt securities, nonvoting preferred stock, and/or nonvoting common stock), but the voting stock is owned by third parties who are frequently executives or major shareholders of the REIT.

Although a preferred stock subsidiary may engage in activities which generate income which does not qualify under the REIT gross income tests (*e.g.*, earning third party management fees), the REIT receives only dividends, which are not bad income, from the preferred stock subsidiary, with the effect that the bad income is cleansed (and qualifies for the 95% test, if not for the 75% test). This structure, however, does not solve the "noncustomary services" problem; if a preferred stock subsidiary performs such services for a tenant of the REIT, "tainting" of the rental income may still occur.

The Act eliminates the preferred stock subsidiary structure and liberalizes the "noncustomary services" rules. On the one hand, a REIT will generally be prohibited from owning securities having a value of more than 10% of the total *value* of the securities of any corporation, as well as securities possessing more than 10% of the *voting power*. On the other hand, in the case of a new of class of entity called a "taxable REIT subsidiary" (or "TRS"), a REIT may own all (or any lesser amount) of the stock. In addition to performing activities formerly performed by preferred stock subsidiaries, a TRS will also be allowed to provide "noncustomary services" to tenants of the REIT without causing the rent from those tenants to be bad income.

Securities of TRS's may not exceed, the aggregate, 20% in value of all of a REIT's assets. This provision, together with the 75% test (which effectively limits dividend income to a maximum of 25% of a REIT's gross income), ensures that the bulk of a REIT's income will continue to be derived from traditional real estate sources.

The availability of the TRS structure is probably the most economically significant change for REIT's under the Act; in light of the sometimes negative view of REIT's in the capital markets, TRS's will help REIT's to increase their revenues from their existing portfolios by generating a variety of new sources of non-rent income. For example, under existing law, if a REIT (or for that matter a preferred stock subsidiary) operated a full service health club open only to tenants in a building, the very first massage administered at the club to a tenant could disqualify the rent from the entire building. Under the new rules, if a TRS operates the health club the rent will *not* become disqualified *and* any net after-tax income generated by operating the health club may be passed through to the REIT as dividends, qualifying under the 95% test.

The Act's *quid pro quo* for the loosening of some of the existing rules is a strict regime designed to ensure that the TRS does in fact pay corporate taxes on its income. Currently, REIT's tend to minimize the corporate-level income taxes of their preferred stock subsidiaries by capitalizing them to a great extent with debt owed to the REIT. The Act aims to preserve the corporate-level tax on the TRS by imposing (i) earnings-stripping rules which limit the amount of interest that the REIT may charge the TRS and (ii) a 100% excise tax to the extent that any amount of interest, rent, or other deduction of the TRS for amounts paid to the REIT is determined to be not at "arm's length."[11]

The Act also aims to give REIT's more financial flexibility by reducing the annual distribution of taxable income that a REIT must make from 95% of taxable income to 90%. REIT's have long complained that the 95% distribution requirement, on the one hand, and market pressure to maintain low debt levels, on the other, hindered their growth capabilities. To the extent that a REIT elects to distribute less than 100% of its taxable income, it is subject a corporate-level tax. Therefore, both tax considerations and market pressure to maintain certain dividend levels may prevent REIT's from taking full advantage of this reduction in the distribution requirement.

Other, more technical REIT rule modifications relate to ownership of debt securities, hotels and healthcare facilities, personal property, earnings and profits, and estimated taxes.

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In the two areas covered by this brief article, as in many other areas, the Act with its innocuous title has made major substantive changes to the tax law.

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1 This provision of the Act does not contain any "grandfather" provisions for sales effected after the date of enactment pursuant to contracts that were binding on that date. However, the Act will not disturb the continued use of the installment method with respect to payments to be received after the date of enactment in connection with pre-enactment sales.

2 Internal Revenue Code section 453(b)(2), (i), (k)(2), (l)(1).

3 Internal Revenue Code section 453A(a)(1), (b)(3), (c).

4 A limited exception will continue to be available for certain sellers of residential lots and timeshares.

5 Internal Revenue Code section 448; Treasury Regulation section 1.446-1(c)(2)(i).

6 H.R. Conf. Rep. No. 478, 106th Cong., 1st Sess. ____ (1999).

7 Treasury Regulation section 1.1031(k)-1(j)(2).

8 *See* Treasury Regulation section 1.1001-3(b).

9 A similar issue may arise in connection with a transfer of property to a partnership. If the transfer is treated as a "disguised sale," the taxpayer might qualify for installment sale treatment, with the effect that the income would be recognized in the year in which the taxpayer received cash consideration, rather than in the year in which the taxpayer's property was transferred to the partnership. *See* Treasury Regulation section 1.707-3(a)(2). Accrual basis taxpayers who engage in such disguised sales will now be taxable in the year of transfer.

10 Internal Revenue Code section 856(c).

11 The excise tax would be imposed, for example, in a case where a REIT rents space to its TRS and that rent is determined to be overstated. Overstating the rent would have the effect of decreasing the taxable income of the TRS (which is subject to a corporate-level tax) and increasing the taxable income of the REIT (which is generally not subject to a corporate-level tax). The draconian penalty of a 100% excise tax is meant to discourage any sort of manipulation in this area.