# IMPLICATIONS AND OPPORTUNITIES OF THE REIT MODERNIZATION ACT

## INTRODUCTION

Congress created REITs in 1960 to allow people to invest in diversified, professionally managed real estate enterprises, but over the past 40 years market dynamics, tenant needs, and physical features of real estate have changed significantly.

Adapting to these changes, on December 17, 1999, Congress and the President signed into law the REIT Modernization Act (RMA), which goes into effect in 2001. This legislation will allow REITs to:

- Remove artificial impediments to corporate and property level activities.
- Compete on a more level playing field and carry out their business plans with greater efficiencies.
- Maximize the array of goods and services provided to tenants and third party customers.
- Become more customer-oriented by providing non-customary tenant-specific goods and services.
- Meet specific tenant needs determined by geographic location.
- Impose greater quality control standards over goods and services delivered to tenants.
- Attract and retain top-quality tenants and management personnel.
- Produce additional income and improve credit worthiness of the firm.
- Strengthen property franchises and customer loyalty.
- Become more competitive, innovative and flexible.
- Evolve while ensuring that they remain real estate oriented.

## HOW IT WORKS

The REIT Modernization Act (RMA) allows a REIT to own up to 100% of the stock of a Taxable REIT Subsidiary (TRS), and lowers the distribution requirement of a REIT from 95% to 90% of gross income. This allows Taxable REIT subsidiaries to provide services to REIT tenants and third parties without disqualifying the rents that a REIT receives from its tenants, and allows a REIT to retain a greater portion of its earnings for investment.

There are size limits on Taxable REIT subsidiaries, and the amount of debt and rental payments made to the affiliated REIT. A 100% excise tax will be imposed on transactions between the subsidiary and the REIT if they are not conducted on an arms' length basis. As of 2001:

- A REIT will not be able to own more than 10%, voting or value, of securities of a non-REIT C Corporation.
    - "Straight debt" securities are excluded from this test as long as the loan rate is fixed and debt securities are non-contingent and convertible.
- A REIT will be able to own more than 10% of a Taxable REIT Subsidiary's securities.
    - Mortgages from the REIT to its Taxable REIT Subsidiary are excluded.
- A REIT will not be able to own more than 10% of a Taxable REIT Subsidiary's securities if the subsidiary engages in a "substantial" new line of business, acquires any "substantial" asset, or if the REIT acquires any new securities in the subsidiary.
- Debt and equity investment in each Taxable REIT Subsidiary will be limited to no more than 20% of the REIT's assets, measured by market value.
- Existing Third Party Subsidiaries (TPS) will be able to convert tax-free into a Taxable REIT Subsidiary.
- Taxable REIT Subsidiaries will be subject to corporate-level income tax, and have the option of distributing after-tax earnings to its affiliated REIT.

These provisions will allow REITs to:

- Exert control over taxable subsidiaries providing services to tenants and third parties.
- Provide more efficient services to tenants and third parties.
- Permit transparent reporting to shareholders since the TRS financial statements will be consolidated with the affiliated REIT.
- Make it easier to integrate Taxable REIT Subsidiary employees into existing compensation plans.

## ACTUAL BUSINESS LINES

Type of services that could be provided to REIT tenants and third parties through Taxable REIT subsidiaries:

Real Estate Related Products and Services:

- Architecture and engineering services
- Real estate brokerage services
- Real estate operations and facilities planning services
- Property management services
- Land development services
- Construction management services

Technology Related Products and Services:

- Internet Service Provider (ISP) services
- Computer software development and consulting services
- Computer hardware and related technology development services

Financial Services:

- Banking and insurance services
- Mortgage banking and brokerage services

Personal and Retail Services:

- Online retailing services
- Wholesale and retail bulk purchasing and distribution services
- Transportation services
- Dry cleaning and house cleaning services
- Entertainment and recreational services

Business Services:

- Education and job training services
- Management, marketing and research services
- Telecommunication services
- Media and communication services
- Electrical power and other utility services

## ACTUAL BUSINESS LINE

For example, a REIT (RealProp) decides to start-up a technology company (TechNet) that will provide Internet access services, hardware technology and computer software applications for online retailing to its tenants.

Under the REIT Modernization Act (RMA), RealProp would be allowed to own up to 100% of the stock in TechNet, a Taxable REIT Subsidiary (TRS). RealProp would probably want to own 100% of TechNet during its start-up phase, and then take the company public through an Initial Public Offering (IPO) once operations have been established. This would allow RealProp to add value by overseeing and providing badly needed telecommunications infrastructure, and strategic planning, working capital, operating and marketing management during the initial incubation period.

After the IPO, RealProp would hold a significant portion of TechNet's total debt and equity (40%), but would provide the market with enough tradable securities (60%) for liquidity, pricing and disclosure purposes. This would allow TechNet to establish itself in the market, communicate with investors, and access both public and private capital market sources for future financing and expansionary needs.

By starting a new company to provide Internet services, develop applications, and sell retail products and services over the web to tenants, RealProp will have more control over product quality and distribution, and will be able to participate in the revenues generated from online retail transactions with its tenants, transactions once provided by third party vendors. Through customized target-marketing efforts, RealProp will also be able to capture and facilitate more retail transactions that were once conducted off-site between tenants and local merchants. By bringing high quality, more affordable, products and services directly to its tenants, RealProp can provide higher levels of customer service and build franchise value in the process.

After-tax net operating income generated from TechNet sales could be held as retained earnings for future financing needs, or after-tax income could be paid out to RealProp as reported earnings. Net operating income generated by TechNet would be taxed at the corporate level. Distributions received by RealProp from TechNet would not be considered "hot" or "bad" income for REIT income test purposes, because it would have already been taxed at the corporate level.

If TechNet was an existing third party subsidiary, RealProp could have TechNet converted into a Taxable REIT Subsidiary tax-free. RealProp will not be able to own more than 10% of TechNet if at some point it enters into a completely different line of business, or acquires another business, that is unrelated to its tenant base or real estate operations.

RealProp will also be limited to the total amount of debt and equity it can own of TechNet. The value of TechNet securities held by RealProp is limited to 20% of the market value of RealProp's gross assets. This in effect would limit the degree of exposure RealProp has to risks associated with owning an e-commerce business. For example, a significant drop in value of TechNet's debt or equity securities would not have a significant impact on RealProp's balance sheet or credit worthiness.

By setting up a Taxable REIT Subsidiary, or converting an existing third party subsidiary to a Taxable REIT Subsidiary, the REIT can have better control over the products and services provided to its tenants, innovate and expand the provision of new and existing products and services, and participate in revenue streams generated from these products and services. By being able to contract through one large service provider, eliminating multiple providers in multiple markets, the REIT benefits from cost savings through economies of scale. Lowering product costs provides savings to tenants and improves profits margins for the subsidiary.

Arms length transactions between the REIT and subsidiary, and the ability of the REIT to fund the subsidiary through the purchase of its stocks and bonds, allows for more transparent reporting. Subsidiary financial statements will be consolidated and reported along with the affiliated REIT. This type of disclosure should help the TRS to access the public markets and improve liquidity in its traded securities.

## SUMMARY

In November 1999, Congress approved and President Clinton signed into law H.R. 1180, also known as the Work Incentives Improvement Act of 1999. Along with other provisions, this legislation included the REIT Modernization Act, which goes into effect January, 1, 2001. This act will allow REITs to own taxable REIT subsidiaries (TRS), and will reduce the distribution requirement of REITs from 95% to 90%.

This legislation is significant for the REIT industry in that it will:

Allow REITs to diversify through expansion and development of new products and services.

- REITs will be able to diversify their product mix and revenue streams away from rent specific sources and risks associated with the real estate cycle.

Allow REITs to generate more low-cost retained earnings for investment purposes.

- Internally generated funds are less expensive then externally generated funds. By not having to go to the debt and equity markets as often, REITs will be able to lower underwriting and reporting costs, and risks associated volatile interest rates and financial markets.

Allows REITs to focus on its core real estate and operations, and customer service through tenant-specific products and services.

- Access to additional low cost funds will allow REITs to increase investment in cost saving and revenue generating technologies. REITs in turn will become:
    - More efficient operators.
        - Investment in supplier-procurement systems, real-time integrated management systems and Intranet web sites will allow REITs to streamline operations, lowering operating expenses in the process.
    - More innovative.
        - Investment in real-time marketing information systems, high-speed Internet access, Extranets and web sites will allow REITs to deliver more products and services to its tenant base, generating additional cash-flow and operating revenues in the process.
    - More Profitable.
        - Lower expenses through streamlining and higher revenues through the sale of new products and services will significantly widen profit margins, improving REIT profitability in the process.