The Development of Taxable REIT Subsidiaries, 2001-2004

by Thornton Matheson

The Real Estate Investment Trust (REIT) Modernization Act, Part II, Subpart A of Public Law 106-170, the "Ticket to Work and Work Incentives Improvement Act," enacted December 17, 1999, created the taxable REIT subsidiary (TRS) in order to allow REITs to offer a more complete range of services to their tenants without jeopardizing their status as REITs. The REIT Modernization Act (RMA) also contained provisions to prevent potential stripping of taxable corporate revenues from TRSs through excessive leverage by subjecting them to section 163(j) of the Internal Revenue Code. A previous study published in the *Statistics of Income Bulletin* analyzed the first year of TRS elections and tax returns, as mandated by the RMA.[1] The purpose of this study is to follow up on that initial investigation with a description of TRS activity over the period 2001-2004.

This study shows that there was rapid growth in TRS firms, assets, and incomes during 2001-2004. TRSs showed increasing profitability over this period, with total net income rising from negative to positive values. TRSs are highly leveraged as a group, with about 30 percent of firms showing negative equity; loans from stockholders constitute less than 4 percent of total TRS debt in any given year. Despite their generally high leverage, roughly 70 percent of TRSs that have loans from stockholders would qualify for exemption from 163(j) restrictions on related-party interest deductibility under either the debt-to-equity ratio test or the excess interest test. Over 2001-2004, TRSs as a group evolved from net interest payers into net interest recipients.

Background

Created by Congress in 1960, REITs provide a vehicle for investment in real estate. As long as an entity otherwise qualifies as a REIT and distributes at least 90 percent of its income to investors as dividends, those dividends are deducted in computing the REIT's taxable income.[2] Two income tests ensure that REITs are used predominantly to invest passively in real estate: (1) at least 95 percent of a REIT's income must be derived from "passive" financial investments, including rents, dividends, interest, and capital gains, as opposed to "active" income from business activities; and (2) at least 75 percent of a REIT's income must be derived from real estate sources, including rents, mortgages, and capital gains on real estate.

REITs are restricted in terms of the kinds of services they can provide their tenants. Specifically, a REIT may provide "customary real estate services" to its tenants, but providing more than a de minimis amount of impermissible services (for example, housekeeping services) at a particular property prevents rents from that property from qualifying as rents under the REIT income tests. REITs argued that the constraints placed on their activities by the "customary services" requirement prevented them from competing effectively with non-REIT real estate firms.

Because REITs were limited in the services that they could provide their tenants directly, before the enactment of the RMA many REITs established third-party subsidiaries (TPSs) to provide such services. Since distributions to the parent REITs from these subsidiaries were dividends, the distributions qualified for the 95-percent income test, but they did not qualify for the 75-percent income test.

In addition to the 95-percent and 75-percent income tests, REITs must also satisfy several quarterly diversification tests, including: 1) the securities of any one issuer must not constitute more than 5 percent of the value of a REIT's total assets; and 2) prior to the enactment of the RMA, a REIT could not hold more than 10 percent of the voting securities of any issuer other than another REIT.[3] In order to comply with the latter test, a REIT would typically own only 10 percent of the voting shares of a TPS; however, it would own close to 100 percent of the value of non-voting stock, preferred stock, or debt. To ensure that the subsidiary acted in the best interest of the REIT, the remainder of the voting shares of the TPS were often held by the REIT's managers or shareholders.[4]

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[1] Thornton Matheson, "Taxable REIT Subsidiaries: Analysis of the First Year's Returns," *Statistics of Income Bulletin*, Spring 2005, Volume 24, Number 4, pp. 114-120.

[2] Between 1980 and 2000, REITs were required to distribute at least 95 percent of their incomes in order for the REIT provisions, including the deduction for dividends paid, to apply. The REIT Modernization Act reduced this ratio to its original 90 percent, equal to the distribution requirement for regulated investment companies (RICs).

[3] The RMA amended the second asset diversification test to require that a REIT hold no more than 10 percent of the vote or value of a non-REIT's securities.

[4] Joint Committee on Taxation (2001), *General Explanation of Tax Legislation Enacted in the 106th Congress*, Washington, DC, U.S. Government Printing Office, p. 68.

The REIT Modernization Act

The RMA allowed REITs to establish taxable REIT subsidiaries, which are subject to the corporate income tax but not to the regular REIT diversification tests. Although securities of a single issuer (other than another REIT) may generally constitute no more than 5 percent of a REIT's assets, securities of one or more TRSs may constitute up to 20 percent of a REIT's assets as measured by fair market value. In addition to the 10-percent limit on REIT holdings of a single entity's voting stock, the RMA added the requirement that a REIT can own no more than 10 percent of the outstanding value of the securities of a single issuer (other than another REIT). Certain exceptions to these rules are allowed: Specifically, a REIT may own 100 percent of the vote and value of a TRS.[5] The RMA also permitted tax-free conversion of TPSs into TRSs. Like dividends from TPSs, dividends from TRSs qualify for the 95-percent income test, but not for the 75-percent income test.

The RMA placed limits on the amount of interest and rents that a TRS can pay to a parent REIT and on what it could charge tenants for its services. For example, the amendment of section 163(j) to apply to interest paid by a TRS to its parent REIT permits deduction of such interest only if the debt-to-equity ratio of the TRS is at most 1.5 or if a TRS has no excess interest, which it defines as net interest expense less 50 percent of adjusted taxable income plus any excess limitation. (These terms will be discussed in greater detail below.) The limitation does not apply to interest on debt held by third parties, even if guaranteed by the parent REIT.

Similarly, for rents paid by a TRS to a parent REIT to qualify as rents from real property for purposes of the 95-percent and 75-percent gross income tests, a TRS may rent no more than 10 percent of any property from a parent REIT and must pay rent comparable to that of other tenants. A 100-percent excise tax is levied on income from certain transactions between a parent REIT and its TRS that are found in an audit to be non-arm's length. The 100-percent excise tax does not apply if: 1) the REIT charges substantially comparable rents to tenants who do and do not receive the TRS services; 2) the TRS charges substantially comparable prices for services to REIT tenants and to unrelated third parties; or 3) the gross income from TRS service charges is at least 150 percent of the direct costs of providing those services.

Analysis of the Data

The data used for this analysis were compiled by the Internal Revenue Service's Statistics of Income Division (SOI) from REIT Form 1120-REIT and TRS Form 1120, *U.S. Corporate Income Tax Return*, and Form 8875, *Taxable REIT Subsidiary Election*. The corporations analyzed are TRSs that filed Form 8875 as well as Form 1120 for Tax Years 2001-2004. The data on these TRSs are from the SOI Corporate Database or the IRS Business Master File (BMF). The BMF includes all corporate tax returns from a given tax year, for which a limited number of items from Form 1120 are available. The SOI Corporate Database is a stratified probability sample of the BMF that captures most Form 1120 entries. Although the Corporate Database generally weights firms according to asset size and income, the data used in this study were selected by employer identification number to match firms that filed Form 8875 in 2001-2004 and are unweighted because they represent the universe of TRSs.

Figure A shows counts of Forms 8875 filed by corporations electing taxable REIT subsidiary status during 2001-2004 and Forms 1120 filed by corporations with employer identification numbers (EINs) matching those on Forms 8875 filed during the same period. Some 463 Forms 8875 were filed in 2001, the initial year that TRSs were authorized by the RMA. Form 8875 filings dropped to less than 100 the following year, but, since then, the pace of annual filings has risen steadily to 286 in 2004. A total of 1,051 Forms 8875 were filed during 2001-2004.

Columns 3 and 4 of Figure A show the number of Forms 1120 in the SOI Corporate Database and Business Master File for corporations whose EINs correspond to the TRS EINs on Forms 8875 filed in the same year or an earlier year during 2001-2004. Because not all TRSs that file Form 8875 subsequently file Form 1120 (presumably, REITs sometimes file TRS elections in order to reserve the option to establish a TRS, and either do not do so at all or do not do

[5] Other exceptions to the 10-percent vote or value restriction include straight debt, mortgage loans from a REIT to its TRS, and certain grandfathered securities held or contracted for by a REIT as of July 12, 1999.

Figure A

Taxable Real Estate Investment Trust Subsidiary Tax Form Filings, Tax Years 2001-2004

Year	Form 8875 initial elections [1]	Form 1120 [2]		
		Total	Statistics of Income corporate database	Business Master File
	(1)	(2)	(3)	(4)
2001	463	379	306	73
2002	99	387	309	78
2003	203	514	200	314
2004	286	704	234	470

[1] Includes all Forms 8875 for which an employer identification number and year of election are present.

[2] Includes SOI and BMF Forms 1120 which have a matching Form 8875 with a year of election, and the year of election is less than or equal to the year of the tax return.

so immediately), the number of TRS 1120s located in either the Corporate Database or the Business Master File is smaller than the number of Form 8875 elections. Some 379 TRSs filed Form 1120 in 2001; the number of TRS Form 1120 filings rises to a peak of 704 in 2004.

Figure B shows summary data on the principal parent REITs listed by TRSs on their Forms 8875. Many TRSs indicate more than one parent REIT on their Form 8875 filings; however, for 2004, data on secondary parent REITs were not processed by SOI. The statistics in Figure B, therefore, reflect only the first parent REIT listed on Form 8875, for which SOI processed data for 2001-2004. Only observations for which a Form 8875 election, a Form REIT-1120 for the parent REIT, and a Form 1120 for the TRS were all filed for a given tax year are reflected in Figure B. Reflecting the growth in the number of TRSs over the period, the number of principal parent REITs climbs steadily from 139 in 2001 to 249 in 2004. The average number of TRSs per parent REIT is about 2.4 over the time period. (Given that only principal parent REITs are included in the data, this number likely overstates the actual average number of TRSs per parent REIT.) Total assets of principal parent REITs grew from $190.6 billion in 2001 to $407.7 billion in 2004, while total income grew from $22 billion to $35.4 billion.

Figure C shows Form 8875 and Form 1120 data for TRSs in either the SOI Corporate Database or the Business Master File for 2001-2004. Only data for TRSs that filed both Form 1120 and a simultaneous or earlier Form 8875 during that period are shown. The data thus represent the total identifiable population of TRSs in each year.

The data in Figure C generally show robust growth in the number, assets, and incomes of TRSs during 2001-2004. The number of TRSs, which corresponds to the sum of columns 3 and 4 in Figure A, rises monotonically from 379 in 2001 to 704 in 2004. Total assets in the TRS sector grew from $16.8 billion in 2001 to a peak of $68.2 billion in 2004, a 47-percent annual growth rate. Total gross receipts also grow rapidly from $9 billion to $17.8 billion between 2001 and 2004, a 23-percent annual growth rate. Total gross profits grow at a similar rate between 2001 and 2004, from $5 billion to $10 billion. Nonoperating income grows more strongly over the time period, from $1.8 billion in 2001 to $6.1 billion in 2004, a 41-percent annual rate. This growth is driven partially by growth in interest received, which rises from $296 million in 2001 to $1.2 billion in 2004, a rate of 46 percent per year. Total TRS income thus grows at an intermediate rate of 29 percent between 2001 and 2004, from $6.9 billion to $16.2 billion.

Total deductions and interest paid grew at roughly the same rate of 25 percent a year between 2001 and 2004, from $7 billion and $457 million to $15 billion and $965 million, respectively. Because interest received grew faster than interest paid, total TRS net interest expense, which is important to the application of 163(j) to TRS related-party interest deductibility, declined from $161 million in 2001 to -$214 million in 2004: that is, over their first 4 years, TRSs as a group shift from being net interest payers to net interest recipients. TRS net depreciation deductions grew from $361 million in 2001 to $618 million in 2004, an 18-percent growth rate.

Figure B

Principal Parent Real Estate Investment Trusts: Selected Items, Tax Years 2001-2004

[Money amounts are in millions of dollars]

	2001	2002	2003	2004
	(1)	(2)	(4)	(3)
Number of REITs [1]	139	154	186	249
Number of TRSs owned	361	360	444	587
Total assets	190,563	204,679	272,281	407,661
Total income	22,045	22,883	27,515	35,449

[1] Includes all real estate investment trusts (REITs) for which Form 8875 was filed and identified as the principle "taxable REIT subsidiary" (TRS); for which Form 1120-REIT was filed; for whose TRSs Form 1120 was filed; and for which the year of Form 8875 election was less than or equal to the year of Forms 1120 and 1120-REIT filings.

Figure C

Selected Items from U.S. Corporation Income Tax Returns for Taxable Real Estate Investment Trust Subsidiaries, Tax Years 2001-2004

[Money amounts are in millions of dollars]

	2001	2002	2003	2004
	(1)	(2)	(4)	(3)
Number of TRSs [1]	379	387	514	704
Total assets	16,776	24,806	40,280	68,235
Gross receipts	8,969	10,418	13,241	17,784
Gross profits	5,048	5,312	7,372	10,048
Nonoperating income	1,803	2,649	3,076	6,120
Interest received	296	350	575	1,179
Total income	6,851	7,961	10,448	16,168
Total deductions	7,045	8,014	10,340	15,001
Interest paid	457	493	641	965
Net depreciation	361	380	470	618
Net income (loss)	-190	-38	143	1,214
Total taxes	84	89	185	388

[1] Includes all "taxable REIT subsidiaries" (TRSs) for which Form 8875 with an election year was filed, which filed Form 1120, and where the year of Form 1120 filing was greater than or equal to the year of Form 8875 election.

TRS tax remittances grew robustly during their first 4 years, albeit from a very small base. Total TRS net income turned from negative to positive over that period, rising from -$190 million in 2001 to $1.2 billion in 2004. Correspondingly, their total tax payments also increased sharply, from $84 million in 2001 to $388 million in 2004, a 51-percent annual growth rate. As a share of gross receipts, total taxes paid increased from 0.9 percent in 2001 to 2.2 percent in 2004.

Figures D and E divide the TRS dataset into two groups depending on their responses to Part III, line 12 of Form 8875, "Did the subsidiary previously file a Federal income tax return?" Figure D includes all TRSs that answer "no" to this question, and are thus considered to be newly established companies, while Figure E includes all TRSs that answer "yes" to this question, and are thus considered to be previously established entities, such as TPSs, that converted to taxable REIT subsidiary status. Six TRSs did not answer this question, and were thus omitted from the data in Figures D and E.

In 2001, preexisting TRSs outnumber newly established TRSs by 232 to 146; however, by 2004, more rapid growth in the population of newly established TRSs leads to their outnumbering preexisting TRSs by 375 to 306. Although both groups have similar average asset size in 2001 ($47 million for newly established TRSs and $42 million for preexisting TRSs), the average asset size of preexisting TRSs grows rapidly over the next 3 years to $165 million, while that of newly formed TRSs remains fairly static, suggesting either that preexisting TRSs grew more rapidly or that preexisting entities converting to TRS status during 2002-2004 were larger than average.

Newly established TRS assets generate income at a higher rate than those of preexisting TRSs during 2001-2004. Although both have similar ratios of total income to total assets of about 41 percent in 2001, for preexisting TRSs, this ratio falls to 18 percent by 2004, while remaining at 38 percent for newly established TRSs. Nonoperating income accounts for a larger share of total income for preexisting TRSs than for newly formed TRSs; although, in 2001, nonoperating income as a share of total income is roughly equal for both groups (29 percent for new TRSs versus 24 percent for preexisting TRSs), by 2004, this ratio doubles to 48 percent for preexisting TRSs while dropping slightly to 26 percent for newly formed TRSs.

Preexisting TRSs were more likely than newly formed TRSs to have negative net income during 2001-2004: whereas newly established TRSs had positive total net income in all years, preexisting

Figure D

Selected Items from U.S. Corporation Income Tax Returns for Newly Established Taxable Real Estate Investment Trust Subsidiaries, Tax Years 2001-2004

[Money amounts are in millions of dollars]

	2001	2002	2003	2004
	(1)	(2)	(4)	(3)
Number of TRSs [1]	146	166	251	375
Total assets	6,914	8,641	9,555	16,494
Gross receipts	4,645	5,827	6,172	8,333
Gross profits	2,026	2,908	3,037	4,602
Nonoperating income	833	1,017	1,182	1,601
Interest received	63	111	99	114
Total income	2,859	3,925	4,219	6,203
Total deductions	2,648	3,791	4,171	5,853
Interest paid	76	98	92	121
Net depreciation	86	107	173	190
Net income (loss)	212	136	59	359
Total taxes	8	21	25	25

[1] Includes all "taxable REIT subsidiaries" (TRSs) for which Form 8875 with an election year was filed, which filed Form 1120, where the year of Form 1120 filing was greater than or equal to the year of Form 8875 election, and where TRS entered "No" on Form 8875, Part III, Line 12.

Figure E

Selected Items from U.S. Corporation Income Tax Returns for Preexisting Taxable Real Estate Investment Trust Subsidiaries, Tax Years 2001-2004

[Money amounts are in millions of dollars]

	2001	2002	2003	2004
	(1)	(2)	(4)	(3)
Number of TRSs [1]	232	216	246	306
Total assets	9,853	16,005	29,995	50,692
Gross receipts	4,324	4,002	6,572	8,697
Gross profits	3,022	2,048	3,861	4,754
Nonoperating income	969	1,607	1,811	4,427
Interest received	232	238	468	1,052
Total income	3,991	3,655	5,672	9,181
Total deductions	4,396	3,831	5,727	8,495
Interest paid	381	383	545	836
Net depreciation	275	265	294	420
Net income (loss)	-403	-164	-32	722
Total taxes	76	68	114	313

[1] Includes all "taxable REIT subsidiaries" (TRSs) for which Form 8875 with an election year was filed, which filed Form 1120, where the year of Form 1120 filing was greater than or equal to the year of Form 8875 election, and where TRS entered "Yes" on Form 8875, Part III, Line 12.

TRSs had negative total net income in all but one year, 2004. Nonetheless, preexisting TRSs paid higher taxes on average than newly formed subsidiaries. The average tax bill for newly formed TRSs over the entire period was $80,000 versus an average of $571,000 for preexisting TRSs. As a percentage of gross receipts, total taxes were 0.3 percent for new TRSs versus 2.4 percent for preexisting subsidiaries over the time period.

In order to distinguish differences among profitable and loss-making TRSs, Figures F and G split the sample of TRSs into firms with negative and nonnegative net incomes. The data show that the growth in the population of TRSs during 2001-2004 was driven by TRSs with negative net income. Whereas the number of TRSs with nonnegative income was essentially flat over this period, fluctuating between 128 in 2001 and 120 in 2004, the number of TRSs with negative net income grew from 251 in 2001 to 584 in 2004. TRS asset growth, however, was driven more by TRSs with nonnegative net income: Average total assets per TRS with negative income were flat at around $20 million during the sample period, whereas average total assets for TRSs with nonnegative income grew from $93 million in 2001 to $466 million in 2004.

The average ratio of total income to assets for TRSs with negative net income was much higher, at 56 percent, versus 18 percent for TRSs with nonnega-

Figure F

Selected Items from U.S. Corporation Income Tax Returns for Taxable Real Estate Investment Trust Subsidiaries with Nonnegative Net Income, Tax Years 2001-2004

[Money amounts are in millions of dollars]

	2001	2002	2003	2004
	(1)	(2)	(4)	(3)
Number of TRSs [1]	128	122	92	120
Total assets	11,912	11,998	32,419	55,892
Gross receipts	1,942	4,791	3,792	7,745
Gross profits	892	1,887	2,364	4,098
Nonoperating income	1,520	1,892	2,191	5,210
Interest received	240	239	470	932
Total income	2,412	3,779	4,555	9,308
Total deductions	1,730	3,010	3,472	7,110
Interest paid	261	243	362	700
Net depreciation	145	121	137	409
Net income (loss)	682	769	1,099	2,198
Total taxes	84	82	175	373

[1] Includes all "taxable REIT subsidiaries" (TRSs) for which Form 8875 with an election year was filed, which filed Form 1120, and where the year of Form 1120 filing was greater than or equal to the year of Form 8875 election.

Figure G

Selected Items from U.S. Corporation Income Tax Returns for Taxable Real Estate Investment Trust Subsidiaries with Negative Net Income, Tax Years 2001-2004

[Money amounts are in millions of dollars]

	2001	2002	2003	2004
	(1)	(2)	(4)	(3)
Number of TRSs [1]	251	265	422	584
Total assets	4,864	12,808	7,862	12,342
Gross receipts	7,027	5,628	9,450	10,039
Gross profits	4,156	3,425	5,009	5,951
Nonoperating income	283	757	883	909
Interest received	56	111	105	248
Total income	4,439	4,182	5,892	6,860
Total deductions	5,315	5,004	6,868	7,891
Interest paid	197	250	279	266
Net depreciation	216	258	333	209
Net income (loss)	-872	-807	-955	-984
Total taxes	0	7	11	15

[1] Includes all "taxable REIT subsidiaries" (TRSs) for which Form 8875 with an election year was filed, which filed Form 1120, and where the year of Form 1120 filing was greater than or equal to the year of Form 8875 election.

tive net income. Nonoperating income accounted for a much larger fraction of total income among TRSs with nonnegative income, at 54 percent, versus 13 percent for TRSs with negative net income. The average ratio of gross profits to gross receipts, at 58 percent, was slightly higher for TRSs with negative net income than for TRSs with nonnegative income, whose average ratio was 51 percent. Of course, TRSs with nonnegative net income paid the vast majority of taxes for the TRS population, at an average of 3.9 percent of gross receipts; however, for reasons that are not clear based on the gathered data, in all years except 2001, some TRSs with negative net income paid positive corporate income tax that was not due to the corporate alternative minimum tax.

In order to gauge the extent to which TRSs might be using (related-party) debt to reduce their taxable incomes and the extent to which 163(j) applies to TRSs, it is necessary to analyze TRS balance sheet data. Figures H and I give balance sheet data from Form 1120, Schedule L from TRSs in the SOI Corporate Database that filled out Schedule L. Corporations with assets and total receipts of less than $250,000 are not required to complete Schedule L. As in Figures C-G, only observations with EINs that match concurrently or previously filed Forms 8875 are included. There are between 186 (2003) and 261 (2002) observations in each year. Some financial statistics described in 163(j) and the corresponding regulations (1.163(j)) had to be approximated from the available data: adjusted taxable income is proxied by net income plus interest paid and net depreciation; excess limitation carryforward is assumed to equal zero. Debt (which excludes short-term trade and operating liabilities) is proxied by the total of mortgages greater than and less than 1 year, loans from stockholders, and other liabilities. Equity is proxied by "computed net worth," the sum of capital stock, paid-in capital surplus, appropriated and unappropriated retained earnings, and adjusted shareholder equity, less the cost of treasury stock.

Like the total Corporate Database and Business Master File sample, the sample of TRSs shown in Figure H shows a decline in net interest expense from positive to negative values over the course of 2001-2004. Since the restrictions on related-party interest deductions in 163(j) apply only to firms with positive net interest expense, firms whose interest received exceeds their interest paid are not subject to those restrictions. On average, slightly less than

Figure H

Selected Items from U.S. Corporation Income Tax Returns, Schedule L for Taxable Real Estate Investment Trust Subsidiaries, Tax Years 2001-2004

[Money amounts are in millions of dollars]

	2001	2002	2003	2004
	(1)	(2)	(4)	(3)
Number of TRSs	253	261	186	225
Net interest expense	172	145	46	-212
Adjusted taxable income	640	861	1,255	2,794
Total assets	16,423	24,480	39,641	67,326
Debt	7,938	13,982	25,708	46,104
Loans from shareholders	136	552	706	632
Equity	6,480	7,065	8,907	13,758
Number of TRSs with net interest expense < 0	111	125	101	105
Number of TRSs with no excess interest	153	166	112	156
Number of TRSs with debt/equity ratio < = 1.5	130	130	84	93
debt/equity < = 1.5 or no excess interest	189	198	138	178
Number of TRSs with negative equity	76	86	53	65

NOTE: TRS is the abbreviation for "taxable REIT subsidiary." In turn, REIT is the abbreviation for real estate investment trust.

Figure I

Selected Items from U.S. Corporation Income Tax Returns, Schedule L for Taxable Real Estate Investment Trust Subsidiaries with Loans from Shareholders, Tax Years 2001-2004

[Money amounts are in millions of dollars]

	2001	2002	2003	2004
	(1)	(2)	(4)	(3)
Number of TRSs	17	16	16	22
Net interest expense	9	21	97	-30
Adjusted taxable income	-18	-34	-1	-72
Total assets	1,043	1,478	3,502	4,223
Debt	657	1,490	3,190	3,635
Loans from shareholders	136	552	706	632
Equity	-47	-387	-422	-35
Number of TRSs with net interest expense < 0	10	10	8	12
Number of TRSs with no excess interest	10	11	10	15
Number of TRSs with either debt/equity < = 1.5 or no excess interest	12	11	10	17
Number of TRSs with negative equity	8	10	9	10

NOTE: TRS is the abbreviation for "taxable REIT subsidiary." In turn, REIT is the abbreviation for real estate investment trust.

half of all TRSs have negative net interest expense in any given year, indicating that they are not subject to 163(j). Even if a firm's net interest expense is positive, however, 163(j) may not disallow its related-party interest deductions if the firm has no "excess interest." Excess interest is defined as net interest expense less 50 percent of the firm's "adjusted taxable income." Although the proposed regulations to 163(j) stipulate a detailed definition of adjusted taxable income, this study approximates adjusted taxable income by adding interest expense and net depreciation back to net income. When 50 percent of adjusted taxable income is subtracted from excess interest, about 63 percent of TRSs have nonpositive excess interest in any given sample year.

Even if a firm has positive excess interest, its related-party debt interest may still be tax-deductible if its debt-to-equity ratio is at most 1.5. The proposed regulations to 163(j) give detailed definitions of debt and equity, which this study proxies as described above. The average debt to total asset ratio for the TRSs in the Corporate Database rose from 48 percent in 2001 to 68 percent in 2004; by contrast, the ratio of equity to total assets declined from 39 percent in 2001 to 20 percent in 2004. On average, 47 percent of all TRSs have positive debt-to-equity ratios of at most 1.5.

In order to qualify for exemption from 163(j) restrictions on related-party interest deductions, a firm must pass either the debt-to-equity ratio test or the excess interest test. On average, about three-quarters of the TRSs in the Corporate Database passed either test in any given year. There is also a fairly high incidence of negative equity among TRSs: About 30 percent of TRSs have negative equity during 2001-2004.

Figure I shows Schedule L data for TRSs with positive loans to shareholders. Very few TRSs report positive loans from stockholders: The number of firms in this category ranges between 16 in 2002 and 2003 and 22 in 2004. On average, 56 percent of these TRSs had negative net interest expense, indicating that 163(j) did not restrict their related-party interest deductions. Total adjusted taxable income was negative for this group in all years. Like the broader sample of TRSs in Figure H, about 65 percent of the TRSs in Figure G have nonpositive excess interest. However, the amount of leverage employed by TRSs with loans from stockholders is generally higher: The average debt to total asset ratio for subsidiaries in Figure I is 88 percent over 2001-2004, and the average equity to total asset ratio is negative in all years, with an average value of -9 percent. In order to preserve taxpayer confidentiality, which prohibits publishing statistics on aggregations of less than three taxpayers, the number of firms with debt-to-equity ratios of at most 1.5 could not be stated. However, about 70 percent of the TRSs with loans from stockholders pass either the excess interest or the debt-to-equity ratio test over the time period. Roughly half of the firms covered in Figure I have negative equity.

Conclusion

The number of taxable REIT subsidiaries increased steadily in the 4 years following the enactment of the REIT Modernization Act: Some 379 TRSs filed Form 8875 and Form 1120 in 2001, after which TRS filings grew steadily to 704 in 2004. During this time, total TRS assets grew from $16.8 billion to $68.2 billion, and total TRS income from $6.9 billion to $16.2 billion. Total TRS net income also turned from negative to positive during this period, rising from -$190 million in 2001 to $1.2 billion. Total taxes paid rose from $84 million (0.9 percent of gross receipts) in 2001 to $388 million (2.2 percent of gross receipts) in 2004. TRSs that converted from preexisting entities were more likely than newly established TRSs to have negative net income; however, they also paid higher taxes relative to gross receipts than newly established TRSs (2.4 percent versus 0.3 percent).

Balance sheet data for taxable REIT subsidiaries included in the SOI Corporate Database indicate that TRSs are generally highly leveraged. About 30 percent of TRSs in the database have negative equity, and about 53 percent have debt-to-equity ratios that are either in excess of 1.5 or less than zero. Nonetheless, 76 percent of TRSs in the Corporate Database pass either the 163(j) debt-to-equity or excess interest test over the 2001-2004 period. Almost half of TRSs (48 percent) had negative net interest expense, and total net interest declined from $172 million in 2001 to -$212 million in 2004. Subtracting 50 percent of adjusted taxable income from net interest expense qualified an additional 16 percent of TRSs for exemption from 163(j) restrictions on related-party interest deductibility.

Loans from stockholders did not account for a large share of taxable REIT subsidiary debt: Total loans from stockholders fluctuated between 1 percent and 4 percent of total debt during 2001-2004, and, at most, 22 TRSs showed positive loans from stockholders in any one of those years. However, those TRSs were even more highly leveraged than the broad sample of TRSs in the Corporate Database. Total equity for TRSs that borrowed from stockholders was negative in every year, as was total adjusted taxable income, and 52 percent of subsidiaries showed negative equity. Nevertheless, 70 percent of these TRSs qualified for exemption from 163(j) restrictions on related-party interest deductibility. About 56 percent of them had negative net interest expense, while an additional 9 percent qualified by having no excess interest after deducting 50 percent of adjusted taxable income from net interest expense. The remaining 5 percent qualified by having positive debt-to-equity ratios of at most 1.5 percent.