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12

MISCELLANEOUS TAX PROVISIONS

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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CONTENTS

INTRODUCTION

This pamphlet presents background information with respect to a series of miscellaneous tax provisions contained in the House-passed bill (H.R. 10612).

In the case of each of the House-passed provisions, the pamphlet describes present law, the issues presented and the House-passed provisions. Other possible miscellaneous provisions will be analyzed for the committee in material to be submitted subsequently.

1. Tax-Exempt Status of Condominium, Cooperative, and Homeowner Associations

Present law

In developing a real estate subdivision, a condominium project, or a cooperative housing project, it is common for developers to form owners' associations as an integral part of the overall development. Generally, membership in the association is open only to owners of lots or dwelling units and is normally required as a condition of ownership. These associations are formed to allow individual homeowners, etc., to act together in managing, maintaining, and improving certain areas where they live. The purposes of the organization may include, for example, the administration and enforcement of covenants for preserving the architectural and general appearance of the development, the ownership and management of common areas such as streets, sidewalks, parks, swimming pools, etc., and the exterior maintenance and repair of property owned by its members.

The association is funded by either annual or periodic assessments of the members. Generally, there are two categories of assessments and expenditures made by the association. First, operating assessments are made to administer, manage, maintain, and operate the areas and facilities common to all residential units. This includes the maintenance of parking areas, hallways, elevators, roofs, exterior of buildings, etc. Second, capital assessments are made to build up reserves for the replacement of equipment and facilities used in common. This includes the equipment and facilities used with respect to swimming pools, tennis courts, clubhouse facilities, etc.

Under present law, generally a homeowners' association may qualify as an organization exempt from federal income tax (under sec. 501 (c)(4) of the Code) only if it meets three requirements. First, the homeowner's association must serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit. Second, it must not conduct activities directed to the exterior maintenance of any private residence. Third, common areas for facilities that the homeowner's association owns and maintains must be for the use and enjoyment of the general public.

If an association is unable to meet these three requirements, it will ordinarily be taxed as a corporation. In general, this means that the excess of current receipts over current expenditures at the end of the year would be taxable to it, unless the excess is refunded to the members or applied to the subsequent year's assessment. With respect to assessments for capital improvements, if the assessments are designated to be used solely for the purpose of making capital improvements and if the association homeowners have an equity interest in the association, the assessments are not current income to the association but may be treated as contributions to capital.[1] Also, to the extent that the association's accumulated funds earn income, this income is taxable to the association.

Issue

Most homeowners' associations have found it difficult to meet the three requirements set forth above, and therefore, do not qualify for tax exemption. To avoid being taxed on the excess of current receipts over current expenditures, a nonexempt association must refund the excess to the members or apply the excess to the subsequent year's assessment.

Since homeowners' associations generally allow individual homeowners to act together in order to maintain and improve the area in which they live, many believe that it is not appropriate to tax the revenues of an association of homeowners who act together if an individual homeowner acting alone would not be taxed on the same activity.

House bill

Under the House bill (sec. 1301), if a qualified cooperative housing association so elects it is not to be taxed on any "exempt function income".[2] Exempt function income includes membership dues, fees, and assessments received from persons who own residential units in the particular condominium, subdivision, or cooperative and who are members of the association.

The association is to be taxed, however, on any net income which is not exempt function income. For example, any interest earned on amounts set aside in a sinking fund for future improvements is taxable. Similarly, any amount paid by persons who are not members of the association for use of the association's facilities would be taxable. Deductions are to be allowed for expenses directly connected with the production of taxable income. The bill provides a $100 deduction against taxable income so that associations with only a minimal amount of taxable income will not be subject to tax.

A cooperative housing association is to be taxed as a corporation on its taxable income. The tax rate to be applied is the corporate rate without the surtax exemption. If the association has net long-term capital gain the capital gain portion of the taxable income is normally to be taxed at a 30-percent rate.

Generally, three different types of homeowners associations may elect to be treated as tax-exempt cooperative housing associations under the bill: Cooperative housing corporations, condominium management associations, and residential real estate management associations.

To qualify for this treatment under the House bill, a cooperative housing association must meet several requirements. First, the associ-

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[1] Rev. Rul. 75–370, 1975–35 I.R.B. 6, indicates that special assessments collected by a nonexempt condominium management association for replacement of the roof and elevators in the condominium are not includible in the association's gross income, and Rev. Rul. 75–371, 1975–35 I.R.B. 7, indicates that special assessments collected by such an association and accumulated for the replacement of personal property used to maintain common areas are contributions to capital.

[2] If the provisions of the bill are not met (or an election is not made to be treated as tax-exempt), a cooperative housing association is to continue to be treated as it is presently treated under existing law.

ation must be organized and operated to provide for the management, maintenance, and care of association property. Although the property maintained by the association is generally property owned by the association and available for common use by all the members, the association may maintain areas that are privately owned but affect the overall appearance and structure of the project.

Second, a cooperative housing association must meet certain income and expenditure tests.

At least 60 percent of the association's gross income must consist solely of membership dues, fees, or assessments from tenant-stockholders, owners of residential units, or owners of residences or residential lots, as the case may be.

Under the expenditure test, at least 90 percent of all of the annual expenditures of the cooperative housing association must be to manage, maintain, and care for, or improve, association property. Qualifying expenditures include both current and capital expenditures on association property.

In addition to the general requirements, in the case of a condominium management association, substantially all of the dwelling units must be used as residences. Similarly, in the case of a residential real estate management association, substantially all the lots or buildings must be used by individuals for residences. In the case of a cooperative housing corporation, the corporation must meet the special definition for cooperative housing corporations under section 216(b)(1).

The House bill would apply to payments received after December 31, 1973, in taxable years ending after that date.

2. Treatment of Certain Disaster Payments

Present law

Under present law (sec. 451(d)), insurance proceeds received by a taxpayer as a result of destruction or damage to crops may be included in income in the year following the year of their receipt, if he can establish that the income from the crops which were destroyed or damaged would otherwise have been properly included in income in the following year.

The provision of present law referred to above was added by the Tax Reform Act of 1969. The purpose of this provision was to avoid the doubling up of income for a cash basis farmer by including crop insurance proceeds in income in the year they were received rather than in the year following the year of receipt, which would generally be the pattern of income receipt from sales of crops.

Because of this doubling up of income in the year of receipt, the farmer would have only deductions and no income to report in the next year and therefore would be likely to have a net operating loss to carry back and offset against income in the prior year. However, the farmer in such cases was faced with the payment of tax and subsequent filing for a refund. He also would lose the benefit of his personal exemptions and his standard or itemized deductions in the year of loss.

Issue

The Agriculture and Consumer Protection Act of 1973 provides that specified payments by the Department of Agriculture are to be made to farmers in the event that either they are prevented from planting crops because of drought, flood, or other natural disaster or, because of the disaster, the total quantity of the planted crops which are harvested is less than 66⅔ percent of the projected yield of the crop. The crops covered by these disaster payments are wheat, corn, grain sorghum, barley, and upland cotton. Premium payments are not required for this protection.

The Service has ruled that the provisions of present law referred to above do not apply to the payments provided to the producers covered by the Agriculture and Consumer Protection Act of 1973 since the proceeds are not insurance proceeds because no premium was paid by the farmer. As a result of the Service's position, these payments must be reported as taxable income in the year of receipt and not in the year in which the income from the sale of the crops would normally be reported.

House bill

The House bill (sec. 1302) provides that in the case of a taxpayer using the cash receipts and disbursements method of accounting, payments received under the Agricultural Act of 1949, as amended by the 1973 Act, would be included in the taxable income of the taxpayer,

70-091—76——2

at his election, in the year in which the income normally received from the crops would have been reported. This provision is to apply only to payments received as a result of (1) destruction or damage to crops caused by drought, flood or any other natural disaster, or (2) the inability to plant crops because of a natural disaster.

The House bill would apply to amounts received after December 31, 1973 in taxable years ending after that date.

3. Tax Treatment of Certain 1972 Disaster Loans

Present law

Under present law (sec. 165), taxpayers are generally allowed to deduct their losses sustained during the taxable year, including losses attributable to fire, storm and other casualty, to the extent that the losses are not compensated for by insurance or otherwise.[3] In the case of any loss attributable to a major disaster which occurred in an area authorized by the President to receive disaster relief, a special rule allows the loss, at the election of the taxpayer, to be deducted on the return for the year immediately before the year of the disaster (that is, the loss may be deducted on the return generally filed in the year the disaster occurs). Where a deduction resulting from a loss is claimed in one year, and compensation is paid for the loss in a later year, the compensation is generally required to be taken into income by the taxpayer in the later year.

Issue

In some cases individuals were hard hit by disasters, such as flood, and claimed a deduction with respect to the disasters, unaware, in many cases, that they might later receive compensation, or partial compensation, for their loss. In some instances, the compensation may be received in a year for which the taxpayer is in a higher tax bracket than he was in for the year for which the disaster loss deduction was claimed. As a result, the taxpayer may be required to pay more tax, with respect to the compensation or reimbursement, than would have been owing if he had not claimed the deduction in the first place.

House bill

Under the House bill (sec. 1303), a taxpayer who received income in the form of a cancellation of a disaster loan, or in the form of compensation in settlement of a tort claim with respect to certain disaster losses sustained in 1972 which were determined by the President to warrant disaster assistance, would be accorded special tax treatment if the cancellation or tort settlement does not exceed $5,000. The tax on the first $5,000 of compensation received in this type of case is not to exceed the tax which would have been payable if the $5,000 (or lesser) deduction had not been claimed. This treatment applies only if the taxpayer elects to come under these provisions. The $5,000 amount would be reduced by $1 for each $1 of the taxpayer's adjusted gross income over $15,000 ($7,500 in the case of a married taxpayer filing a separate return) for the year in which the deduction for the loss was taken.

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[3] Individuals generally are allowed to deduct their losses of property (not connected with their trade or business) only to the extent that the loss exceeds $100; losses attributable to an individual's business are fully deductible.

The election may be made for up to $5,000 of compensation paid in a year after the year for which the loss deduction is claimed and which results either (1) from the forgiveness or cancellation of a disaster loan under section 7 of the Small Business Act or an emergency loan under subtitle C of the Consolidated Farm and Rural Development Act, or (2) from a payment made to the taxpayer in settlement of a tort claim which the taxpayer had against another person.

Any compensation or reimbursement in excess of the $5,000 limitation must be taken into income by the taxpayer for the year in which the payment is received.

The House bill also provides that any tax with respect to this $5,000 (or lesser) amount still unpaid on October 1, 1975, may be paid in three equal annual installments, with the first installment payable on April 16, 1976. Also, no interest on any deficiency with respect to this $5,000 amount is to be payable for any period prior to April 15, 1976, and no interest is to be payable on any installment payment before the due date for that installment.

4. Tax Treatment of Certain Debts Owed by Political Parties to Accrual Basis Taxpayers

Present law

Under present law (sec. 271), any deduction generally allowable for bad debts or for worthless securities is not allowed for a worthless debt owed by a political party. This rule applies to all taxpayers other than a bank, but, where the debt arises out of the sale of goods or services, the rule in practice affects only taxpayers utilizing the accrual method of accounting (because only these taxpayers would have taken into income the receipts which give rise to the debt).

Present law for this purpose defines political parties to include all committees of a political party and all committees, associations, or other organizations which accept contributions or make expenditures on behalf of any individual in any Federal, State or local election.

Issue

It has been pointed out that the disallowance of a bad debt deduction for debts owed by political parties means that taxpayers who are in the business of providing goods or services (such as polling, media, or organizational services) to political campaigns and candidates are treated less favorably than taxpayers in virtually any other business because they are not able to deduct bad debts which arise in the ordinary course of their business.

It is noted that this provision disallowing any bad debt deduction was originally enacted to prevent tax deductions for concealed contributions. However, it is argued that since, in the case of the sale of goods or services, the deduction is allowed only if the amount of gross receipts which gave rise to the debt has been included in taxable income, the effect of the provision is to tax these individuals on income which they have never received.

Furthermore, since present law does not affect cash basis taxpayers who sell services for political campaigns (because in that case no amount is taken into income), it is suggested that the provision discriminates against taxpayers whose business differs from others only in that they are on the accrual method of accounting.

House bill

The House bill (sec. 1304) adds an exception to the provision disallowing a deduction for bad debts owed by political parties. The exception applies only to taxpayers who use the accrual method of accounting. These taxpayers are to be allowed a bad debt deduction with respect to debts which are accrued as a receivable in a *bona fide* sale of goods or services in the ordinary course of their trade or business. The bill limits this exception to those cases in which 30 percent of all of the receivables accrued in the ordinary course of all of the trades or businesses of the taxpayer are due from political parties. Also, the bad debt deduction is to be allowed only if the taxpayer has made substantial continuing efforts to collect on the debt.

Under the House bill, this provision applies to taxable years beginning on or after January 1, 1975. It also applies to taxable years beginning before January 1, 1975, for which the assessment of a deficiency, or the making of a refund, or the allowance of a refund or credit of any overpayment, is not barred on the date of enactment of this provision.

5. Clarification of Definition of Produced Film Rents

Present law

Under present law, a corporation which is a personal holding company is taxed on its undistributed personal holding company income at a rate of 70 percent. A corporation may be a personal holding company where five or fewer individuals own 50 percent or more in value of its outstanding stock and where at least 60 percent of the corporation's adjusted ordinary gross income comes from specified types of passive income.

One income category treated as personal holding company income is "produced film rents." Generally, this category covers payments received by the corporation from the distribution and exhibition of motion picture films if these rents arise from an "interest" in the film acquired before its production was substantially completed. Produced film rents are not treated as personal holding company income, however, if such rents constitute 50 percent or more of the corporation's ordinary gross income. The qualifying rental interest under this category is one which arises from participation in the production of the film.

Payments received from the use of, or right to use, a film are treated as copyright royalty income, if the corporation's interest in the film is acquired after production was substantially completed.

Amounts received under a contract under which the corporation is to furnish personal services may also be classified as personal holding company income.

Issue

A question concerning the proper definition of produced film rents, for purposes of the personal holding company rules, has resulted from a recent decision by the Tax Court[4] which denied depreciation deductions to an independent production company which produced an original motion picture with nonrecourse financing supplied by a major studio-distributor under an agreement that, on completion, all rights to the picture except a share in distribution profits vested in the distributor. The court held that, in these circumstances, the production company had no ownership interest in the film after it was completed and therefore could not depreciate the costs of producing film.

Although this case involved depreciation rather than personal holding company issues, it appears that the Internal Revenue Service has interpreted the decision to require that an "interest" in a film, for purposes of the definition of produced film rents in sec. 543(a)(5), must be a depreciable interest. If a production company has only a profit participation after the picture is completed and released, but legally does not have an ownership interest sufficient to claim deprecia-

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[4] Carnegie Productions, Inc., 59 T.C. 642 (1973).

tion, some revenue agents have treated all of the company's income as personal service contract income (under sec. 543(a)(7) of present law).

The issue is whether this treatment is appropriate, for personal holding company purposes, or whether a production company's right to participate in income or profits should be treated as produced film rents (thus helping the corporation to escape personal holding company status if the rents exceed 50 percent of the corporation's ordinary gross income), if this income arises from *bona fide* production activities in the making of the film (regardless of whether the profits interest is depreciable).

House bill

Under the House bill (sec. 1305), in the case of a producer who actively participates in the production of a film, the term "produced film rents" for purposes of personal holding company income would include an interest in the proceeds or profits from the film, but only to the extent such interest is attributable to such active participation.

This provision would apply to taxable years ending on or after December 31, 1975.

6. Prepublication Expenses

Present law

Present law (sec. 174(a)(1)) permits, under certain circumstances, a deduction for research and experimental expenditures otherwise chargeable to a taxpayer's capital account. The regulations under this provision define research and experimental expenditures as expenditures incurred in connection with a taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. Specifically excluded are expenditures for research in connection with literary, historical, or similar projects.

In Rev. Rul. 73–395,[5] the Internal Revenue Service held that the costs incurred by an accrual basis taxpayer in the writing, editing, design and art work directly attributable to the development of textbooks and visual aids do not constitute research and experimental expenditures under section 174. The Service further held that these costs cannot be inventoried (under sec. 471) but instead represent expenditures that must be capitalized (under sec. 263) and may be depreciated (under sec. 167(a)).

However, the ruling also stated that expenditures incurred in the actual printing and publishing of textbooks and visual aids should be inventoried (under sec. 471) with a part of the costs being apportioned to the books and visual aids still on hand at the end of the taxable year. Also, expenditures for manuscripts and visual aids that are abandoned may be deductible as losses (under sec. 165).

In addition, the Service anounced (in Rev. Rul. 73–395) that it would not follow the decision of the United States District Court, Central District, California, in *Stern* v. *United States*,[6] which held that a taxpayer, in the business of writing books, could deduct traveling expenses incurred while researching, writing and arranging material for a book.[7]

On March 17, 1976, the Internal Revenue Service announced [8] that it has begun a study project as a result of questions regarding the application of Rev. Rul. 73–395 to certain prepublication expenses of the publishing industry. The Service will study the application of sections 162 (dealing with the deduction of trade or business expenses), 263 (treatment of capital expenditures), and 471 (general rule for inventories) to prepublication costs within different segments of the industry.

[5] 1973–2 C.B. 87.

[6] 1971–1, U.S.T.C. 9375. The case involved two issues: (1) whether the taxpayer was engaged in the business of writing, and (2) whether traveling expenses were deductible as ordinary and necessary business expenses or constituted non-deductible expenditures for the improvement of a capital asset.

[7] The Government said that it did not appeal the case because it had erroneously stipulated to the effect that "if the taxpayer was determined to be in the business of being a writer, the traveling expenses in question were ordinary and necessary."

[8] Press Release IR–1575.

The Service stated that the application of these sections is not adequately explained in Rev. Rul. 73-395, and that the project is expected to result in the publication of regulations and/or additional revenue rulings. It is also likely that Rev. Rul. 73-395 will be modified and clarified or superseded.

Pending completion of this project, the Service is suspending audit and appellate activity with respect to cases in which the deductibility of these prepublication expenses is an issue. No further action will be taken in these cases except as necessary to protect the interest of the Government.

The announcement did not indicate whether the Service, as part of the project, will reconsider its determination not to follow the *Stern* decision.

Issue

The treatment of prepublication expenditures involves two general issues: first, whether it is desirable to require the capitalization of prepublication expenses; and second, the correct application of the Internal Reveue Code to those expenses.

The interpretative issue arises because historically industry members claim that they generally have deducted prepublication expenses currently and that until the publication of Rev. Rul. 73-395 the Service has seldom questioned this practice. Rev. Rul. 73-395 generally requires capitalization.

Rev. Rul. 73-395 also affects writers. Taxpayers in the business of writing claim that prepublication expenditures are trade or business expenses which are currently deductible (under sec. 162), as the *Stern* case held, and do not constitute capital expenditures.

House bill

The House bill was passed before the Service announced its study project on the tax treatment of prepublication of expenditures and Rev. Rul. 73-395.

The bill (sec. 1306) allows taxpayers to treat their prepublication expenditures in the manner in which they have been applied consistently by the taxpayer in the past until new regulations are issued with regard to these expenditures after the date of enactment of the bill.

Any regulations issued by the Internal Revenue Service would apply only to taxable years beginning after their issuance. Until these regulations are issued, the Internal Revenue Service would administer the application of sections 162, 174 and 263 to publishers' prepublication expenditures without regard to Rev. Rul. 73-395. In addition, as indicated above, the Service would administer these sections in the same manner as they were consistently applied by taxpayers prior to the issuance of Rev. Rul. 73-395. If a taxpayer did not consistently follow a specific tax accounting method, his returns would be treated by the Service in accord with usual administrative procedures.

The prepublication expenditures affected by the House bill are those paid or incurred in connection with the taxpayer's trade or business of publishing for the writing, editing, compiling, illustrating, designing or other development or improvement of a book, teaching aid, or similar product.

7. Real Estate Investment Trusts

Present law

Under present law, real estate investment trusts ("REITs") are provided with the same general conduit treatment that is applied to mutual funds. Therefore, if a trust meets the qualifications for REIT status, the income of the REIT which is distributed to its owners each year generally is taxed to them without being subjected to a tax at the REIT level (the REIT being subject to tax only on the income which it retains and on certain income from property which qualifies as foreclosure property). Thus, the REIT provides a means whereby numerous small investors can invest in real estate assets under professional management and allows them to spread the risk of loss by the greater diversification of investment which can be secured through the means of collectively financing projects which the investors could not undertake individually.

In order to qualify for conduit treatment, a REIT must so elect and must satisfy four tests on a year-by-year basis; organizational structure, source of income, nature of assets, and distribution of income. These conditions are intended to allow the special tax treatment for a REIT only if there really is a pooling of investments which is evidenced by its organizational structure, if its investments are basically in the real estate field, and if its income is clearly passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the income of the REIT must be passed through to its shareholders on a current basis.

With respect to the organizational structure, a REIT, in general, must be an unincorporated trust or association (which would be taxable as a corporation but for the REIT provisions) managed by one or more trustees, the beneficial ownership of which is evidenced by transferable shares or certificates of ownership held by 100 or more persons, and which would not be a personal holding company even if all its adjusted gross income constituted personal holding company income.

With respect to the income requirements, at least 75 percent of the income of the REIT must be from rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (or interests therein, including mortgages), distributions from other REITs, and abatements or refunds of taxes on real property and income and gain derived from property which qualifies as foreclosure property. An additional 15 percent of REIT income must come from these sources, or from other interest, dividends, or gains from the sale of securities. Income from the sale or other disposition of stock or securities held less than 6 months, or real property held less than 4 years (except in the case of involuntary conversions) must be less than 30 percent of the REIT's income.

With respect to the asset requirements, a REIT must have at least 75 percent of the value of its assets in real estate, cash and cash items, and Government securities. However, not more than 5 percent of the assets can be in securities of any one nongovernment, non-REIT issuer, and these holdings may not exceed 10 percent of the outstanding voting securities of such issuer. Also, no property of the REIT other than foreclosure property, may be held primarily for sale to customers.

In addition, a REIT is required to distribute at least 90 percent of its income (other than capital gains income and certain net income from foreclosure property, less the tax imposed on such income by section 857) to its shareholders during the taxable year, or declare it as a dividend by the due date for filing its tax return for the year (including any extension) and pay the dividend within 12 months from the close of the taxable year.

If all of these conditions are met, then the REIT generally is qualified for the special conduit treatment which allows the income that is distributed to the shareholders to be taxed to them without being subjected to a tax at the trust level, so that the REIT is only taxed on the undistributed income and certain income from foreclosure property. Otherwise, a trust that does not meet the requirements for qualification as a REIT would be treated as a corporation, in which case all of its income would be taxed to the REIT, not just the undistributed income.

Issue

Although the provisions have been amended from time to time, until 1974 the basic rules with respect to REITs have remained the same since their enactment in 1960. (In 1974, the Congress dealt with the difficulty a REIT may have in meeting the income and asset tests if it must foreclose on a mortgage that it owns or reacquire property which it owns and has leased). Since 1960, the REIT industry has grown enormously in size and is responsible for a large portion of the investment in the real estate field in the United States today. However, industry representatives have stated that problems have arisen with respect to the REIT provisions which could significantly affect the indstry if they are not modified.

These problems relate to the fact that under present law if a REIT does not meet the various income, asset, and distribution tests. The REIT will be disqualified from using the special tax provisions even in cases where the failure to meet a requirement occurred after a good faith, reasonable effort on the part of the REIT to comply. Disqualification would have the effect of not only changing the tax status of the REIT itself, subjecting its income to tax at corporate rates, but also could adversely affect the interests of the public shareholders of the REIT. Questions have been raised as to whether it is appropriate to disqualify a REIT in such circumstances.

House bill

In general, the House bill (secs. 1601–1606) makes the following changes with respect to the provisions of the tax law relating to REITS:

(1) As discussed above, under present law, a REIT generally is required to distribute 90 percent of its taxable income each year to its shareholders. If it does not meet this requirement, the trust will be disqualified as a REIT and thus must pay tax on its income as if it were a regular corporation. Under the House bill, a REIT will not be disqualified if it is determined, on audit, that the failure to meet the 90-percent distribution requirement was due to reasonable cause. In this case, the REIT is to be allowed to distribute deficiency dividends to its shareholders to avoid disqualification. However, interest and penalties are to be imposed on the amount of the adjustment under this procedure.

(2) Under present law certain percentages of a REIT's income must be derived from designated sources. The House bill provides that if a REIT were found to have failed to meet the income source tests, it would not be disqualified, but would be allowed to pay tax on the amount by which it failed to meet the income source tests. This provision would be available only if the REIT initially had reasonable ground to believe that it had met the income source tests.

(3) Present law prohibits a REIT from holding property (other than foreclosure property) for sale to customers. The House bill eliminates the "holding" prohibition and substitutes a limit on the amount of income a REIT can derive from property so held. Under the House bill, a REIT could have a *de minimis* amount (up to one percent) of its gross income from such sources, and this income would be subject to corporate tax. Any income from such sources in excess of one percent would be subject to an additional tax under the provisions discussed above, but would not disqualify the REIT, provided the REIT had reasonable grounds to believe that the excess income was not holding-for-sale income.

(4) The House bill also provides that certain types of income that customarily are earned in a real estate business but which do not now qualify under the income source tests are to be treated as qualifying income. These include (a) certain rents from personal property leased together with the real property; (b) charges for services customarily furnished in connection with the rental of real property whether or not such charges are separately stated; and (c) commitment fees received for entering into agreements to make loans secured by real property.

(5) The income source requirements are increased by the House bill so that at least 95 percent of the REIT's income must be from passive sources. Also, all income, other than passive income, would be subject to corporate tax.

(6) Under the House bill, a REIT would be permitted to operate in corporate form; under present law, a REIT must operate as a trust or association.

(7) Under the House bill, a REIT would be required to designate the year to which a dividend payment relates. (Under present law, a dividend may relate either to the year in which it is paid, or the immediately preceding year in most cases.) Also, a REIT is to be subject to a 3 percent charge on the amount by which it fails to distribute at least 75 percent of its income in the year received. In addition, a new REIT would be required to be on a calander year for tax purposes.

(8) Certain other changes are made concerning technical rules applicable to REIT's, including changes in the rules regarding income from sale of mortgages held for less than four years, and regarding options to purchase real property.

Under the House bill, the provisions outlined above would apply generally to taxable years of real estate investment trusts beginning after the date of enactment.

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