DIVIDENDS, REAL ESTATE AND TAX REFORM

Policy Guidelines

May 2003

Under current law, fewer than half of all real estate brokerage and investment businesses are organized as so-called C Corporations, and almost none are publicly traded entities. Further, real estate businesses generally are not organized in such a way that they regularly distribute dividends. Accordingly, one might reasonably conclude that the taxation of dividend income is not relevant to ownership of and investment in real estate brokerages or real estate assets.

The taxation of dividend income can be relevant to real estate, however, in the context of an investor's decisions about whether to invest in securities or real estate. If the tax rate on dividends derived from investment in securities were to drop to zero, investors might be drawn away from real estate. Similarly, the design of a dividend exclusion could change capital gains results. The structure of a dividends exclusion could also modify the rates of return or pricing structure of various tax credit incentives, including the current law low-income housing rental credit and a proposed credit intended to increase the supply of affordable housing available for purchase.

In January 2003, President Bush proposed a sweeping reform for the taxation of corporate dividends. Under current law, dividends are often taxed twice: once as taxable income at the corporate level and again as ordinary income for taxable recipients. Thus the marginal tax rate on corporate dividends can exceed 70 percent. The President's proposal is designed to assure that all corporate income is taxed once, but only once.

The President's proposal would exclude from taxation any dividends received by individuals or taxable entities. Under the proposal, an individual may exclude dividends from taxation *only* if the corporation has paid tax on the income. If a corporation chooses to retain its earnings, the proposal provides a basis adjustment for the shareholder. This basis adjustment has the effect of reducing capital gains burdens when the stock is sold. These new features of income measurement will add significant new complexities into the Code for both corporations and individuals.

(Note that a substantial portion of all publicly traded stock is owned by pension funds, mutual funds and other non-taxable entities. The treatment of dividends paid to those non-taxable entities will remain unchanged.)

Of direct concern to real estate is the impact of the President's proposal on low-income housing. Currently about 40 percent of all affordable units in the country are financed with low-income housing tax credits. The primary market for those credits has been Fannie Mae, Freddie Mac and a relatively small group of large corporations engaged in the manufacturing and financial services industries. The President's proposal does not directly alter the credit in any way. The proposal does, however, significantly alter the investment analysis of corporations that may wish to utilize the credit.

Under the President's proposal, any investment choice that a corporation makes that has the effect of reducing the corporation's tax liability will also reduce the amount of dividends that can be distributed tax-free. Because the low-income housing credit reduces tax liability, there is concern that corporations will reduce their investment commitment to credit projects. This will increase the cost of capital for low-income housing projects, thereby reducing the number of units developed annually. Studies to date all show that the President's proposal would make investment in low-income housing more costly to the investor, but the studies vary in their assessment of the severity of the impact.