Statement of the
National Association of Real Estate Investment Trusts®
to the
Committee on Ways and Means
U.S. House of Representatives
Regarding H.R. 5395
Tax Technical Corrections Act of 2004
January 31, 2005

As requested in Press Release No. FC-21 (November 23, 2004), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Committee on Ways and Means' review of H.R. 5395, the Tax Technical Corrections Act of 2004 (the TTCA). As stated in Press Release No. FC-21, the TTCA includes technical corrections to, among other things, the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (the Act). NAREIT thanks the Chairman and the Committee for the opportunity to provide these comments.

NAREIT is the national trade association for REITs and publicly traded real estate companies. Members are real estate investment trusts (REITs) and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. NAREIT represents over 190 REITs and publicly traded real estate companies and over 1,500 professionals who provide legal, investment and financial services to these companies.

EXECUTIVE SUMMARY

By way of background, the Act contains all three titles of the NAREIT-supported REIT Improvement Act (RIA), which are summarized below. First, as relevant here, Title I of the RIA includes a number of provisions, including one that allows a REIT to make certain loans in the ordinary course of business without the risk of losing REIT status. Second, Title II of the RIA substantially conforms the treatment under the FIRPTA rules of foreign shareholders in publicly traded REITs to that of foreign shareholders in other publicly traded U.S. companies. Finally, Title III of the RIA (the REIT Savings provisions) allows REITs to avoid REIT disqualification for non-intentional REIT test violations either by, among other things, paying a monetary penalty if the violation was due to reasonable cause or, for certain *de minimis* violations, by bringing themselves into compliance with the REIT rules.

NAREIT appreciates Congress' leadership in enacting this important legislation. However, certain provisions of the Act could result in retroactive REIT disqualification and/or considerable additional expense for REITs that complied with prior law or comply with the new law. Accordingly, and as further described below, NAREIT respectfully requests that any technical corrections legislation Congress considers in 2005 reflect the items set forth in these comments.

The specific items are as follows:

1) a clarification of the transition rule relating to the definition of "hedging transaction" for purpose of the REIT tests, so that the new provisions apply only to transactions entered in taxable years beginning after December 31, 2004;

2) a transition rule concerning the calculation of "safe harbor securities" under § 856(m)(1), in order to prevent retroactive disqualification of REITs that complied with the provisions of pre-Act § 856(c)(7);

3) a clarification of the effective date of the "REIT Savings" provisions of the Act, so that "foot faults" that occurred prior to, but were discovered after, taxable years beginning after the Act's date of enactment are eligible for the REIT Savings provisions of the Act.

4) a clarification of the "REIT Savings" provisions of the Act, in order to enable REITs that incur a "*de minimis*" violation of certain REIT asset tests to cure their violations rather than risk losing REIT status;

5) a clarification of the effective date of the "deficiency dividend" procedure, so that the provision applies to "determinations" made in taxable years beginning after October 22, 2004; and,

6) a clarification of the effective date and testing period of the new FIRPTA provisions of the Act, so as to apply by reference to the REIT's taxable year with a special rule for deficiency dividends paid after the date of enactment;

DISCUSSION

A. New Hedging Rule

1. Background

Prior to the Act, § 856(c)(5)(G) of the Internal Revenue Code of 1986, as amended (the Code) provided generally that any amounts a REIT realized from any hedge of real estate debt "to reduce interest the interest rate risks" with respect to indebtedness incurred by the REIT to carry real estate assets qualified as good REIT income for purposes of the 95% gross income test.

The Act replaces § 856(c)(5)(G) with a provision that conforms the definition of a hedge to the general Code provision in § 1221, and disregards any hedge income in computing the 95% test. One requirement of the new provision is that the hedging transaction be "clearly identified pursuant to section 1221(a)(7)". Under § 1221(a)(7), a "hedging transaction" must be clearly identified by the close of the day in which it is entered into, and under Treas. Reg. § 1.1221-2(f)(2)(ii), the risk being hedged must be identified within 35 days thereafter. The purpose of complying with § 1221(a)(7) and clearly identifying a hedging transaction as such is to allow the taxpayer to treat the gain or loss from such a transaction as ordinary, rather than capital. Treas. Reg. § 1.1221-2(g)(2)(ii) contains a provision for failure to identify due to "inadvertent error." However, the purpose of this provision is to treat the gain or loss from a hedging transaction as ordinary, rather than to treat such transaction as "clearly identified". The effective date of the new REIT hedging rule is taxable years beginning after October 22, 2004 (the Act's date of enactment).

2. Issue

The need to treat income as ordinary generally is not important for REIT qualification purposes inasmuch as most REITs distribute all of their taxable income, whether ordinary or capital in nature. Thus, many REITs did not identify hedges under prior law because the Code did not require the same for REIT tax purposes. This failure to identify would result in such REITs holding hedges that complied with pre-Act law but would generate "bad" income under the 95% gross income test after January 1, 2005.

Under the Act, REITs that fail to identify their hedging transactions face having to treat the income from such transactions as "bad" income, thereby potentially jeopardizing REIT status and/or causing significant expense.

3. Proposed Solution

We urge that any technical corrections legislation include a clarification that the effective date of the new hedging provision applies to hedging transactions entered into after December 31, 2004. Please note that § 414 of the Act, which also applies the § 1221(a)(7) definition of hedging transaction in the international area, uses this effective date. This effective date would prevent REITs that complied with pre-Act § 856(c)(5)(G) from being penalized.

B. Transition Rule for Retroactive Application of 1% Threshold in Disqualifying Otherwise Qualifying "Safe Harbor" Securities

1. Background

Congress passed the REIT Modernization Act (RMA)[1] to update the rules governing REITs to permit them to own taxable subsidiaries (TRSs) that can engage in business operations not permitted to REITs. In exchange for permitting this new TRS arrangement, the RMA added an

[1] Sections 451-571 of Pub. L. No. 106-107, the Ticket to Work and Work Incentives Improvement Act of 1999.

additional rule to the existing REIT asset tests: it prohibited REITs from owning more than 10% of the value of any other entity's securities (the 10% value rule). § 856(c)(4)(B)(iii)(III).

Of significant importance in compliance with the asset test is that under § 856(c)(5)(F), for purposes of the REIT rules, terms not defined within § 856 (such as "securities") have the same meaning as when used in the Investment Company Act of 1940, as amended (the 40 Act). The 40 Act defines a "security" to include any note, stock, treasury stock, bond, debenture or evidence of indebtedness. An "issuer" is defined as any natural person or company who issues or proposes to issue any security, or has outstanding any security which it has issued. Accordingly, most debt instruments, issued by virtually any type of issuer, constitute "securities" for purposes of the REIT asset tests.

Although the 10% value rule was intended to prevent REITs from owning more than 10% of the equity of another corporation, because of the 40 Act's inclusion of most debt instruments in the definition of "securities", the rule potentially applied to many situations when individuals and businesses owe some sort of debt ("security" defined broadly) to a REIT. The RMA did provide a safe harbor for "straight debt" securities under prior law's § 856(c)(7).

Specifically, § 856(c)(7) (prior to amendment by the Act) provided that securities of an issuer which satisfied the definition of straight debt in § 1361(c)(5) (without regard to subparagraph (B)(iii) thereof) would not be taken into account in applying the 10% value test if: (A) the issuer were an individual; (B) the only securities of the issuer which were held by the REIT or a TRS of the REIT were straight debt (as so defined); or, (C) the issuer were a partnership and the REIT held at least a 20% profits interest in the partnership.

Accordingly, under the RMA, in order for a loan made by a REIT to a partnership in which it held any equity (or non-"straight debt") interests to qualify for the "straight debt" safe harbor of § 856(c)(7), the REIT was required to hold at least a 20% profits interest in that partnership. Under this provision, non-"straight debt" securities worth less than 10% of the partnership's outstanding securities issued by a partnership to a REIT that owned at least a 20% profits interest in the partnership as well as straight debt securities issued by the partnership (even straight debt securities in excess of 10% of the partnership's outstanding securities), would not, by themselves, cause the REIT to violate the 10% value test. The non-straight debt securities would be considered "securities" for purposes of the 10% value test, but they would not cause the straight debt securities to be considered non-"straight debt" securities.

Unfortunately, even with the straight debt safe harbor under the RMA, there were a number of situations in which the REIT could extend loans in the ordinary course of its business, which, if worth more than 10% of the issuer's outstanding securities, could have caused the REIT to violate the 10% value rule.

2. The Act's Change to Requirements in Connection With Loans to Partnerships

NAREIT applauds Congress' decision to include in the Act many beneficial changes to the straight debt safe harbor that, in the vast majority of cases, enable REITs to continue to operate in the normal course of business without fear of de-REITing. The Act makes these changes by exempting from the 10% value test specific categories of loans that are non-abusive and present little or no opportunity for the REIT to participate in the profits of the issuer's business, such as loans to individuals or any obligations to pay rents from real property. *See* § 856(m)(1)(A)-(G), as enacted by the Act. These rules are effective as though enacted along with the RMA (*i.e.*, they are retroactive for taxable years beginning after December 31, 2000). For purposes of this letter, debt securities that satisfy the definitions in § 856(m)(1) are designated "safe harbor securities".

The Act adds a number of provisions to the Code for purposes of the 10% value test, including § 856(m)(2)(C). This provision is retroactive, applying to taxable years beginning after December 31, 2000. Section 856(m)(2)(C) provides, among other things, that, if a REIT owns both (i) otherwise qualifying safe harbor securities in a partnership and (ii) securities in such partnership that are not safe harbor securities and whose value exceeds more than 1% of such partnership's outstanding securities, the otherwise qualifying "safe harbor securities" may be disqualified from being considered safe harbor securities. In this case, if the aggregate value of the total debt securities issued to the REIT by the partnership exceeds 1% of the partnership's outstanding securities, the REIT may fail the 10% value test, and the REIT may lose REIT status.[2] Moreover, such loss of REIT status could be retroactive to taxable years as far back as 2001.

3. Issue

Under the Act, a REIT that owned the following securities in a partnership prior to the effective date of the Act would not have failed the 10% value test due to the ownership of these securities under prior law but would fail the 10% value test retroactively after the Act: (a) at least a 20% profits interest in the partnership; (b) "straight debt" securities under § 856(c)(7) (and under § 856(m)(1) prior to the application of § 856(m)(2)(C)) with an aggregate value in excess of 10%

[2] There are two provisions of the Act that may provide relief to a REIT in this situation if other facts are present. Specifically, § 856(m)(4)(A) provides a "self charged rule": any non-safe harbor debt issued to a REIT by a partnership will not be considered a security to the extent of a REIT's interest in the partnership (the Self-Charged Rule). Additionally, if at least 75% of the partnership's gross income consists of "real estate-related" income under § 856(c)(3) (a Real Estate Partnership), then under § 856(m)(4)(B), its debt instruments are not considered "securities". For purposes of this letter, it is assumed that, even after application of these two provisions, the REIT is viewed as owning non safe harbor securities worth more than 1% of the partnership's outstanding securities. Examples of a non-Real Estate Partnership to which a REIT may have extended both a straight debt and non-straight debt loan would be a health care operator or a service partnership between a TRS and an independent contractor.

of the partnership's outstanding securities; and (c) non-"straight debt" securities with an aggregate value greater than 1%, but less than 10%, of the partnership's outstanding securities.[3]

Such a result could have a devastating impact on its business and its shareholders – an impact which is overly harsh for a REIT that had no recourse but to rely on the plain language of prior law and can take no current action to improve its situation.[4]

4. Proposed Solution

We urge that any technical corrections legislation include either of the following two alternatives as solutions for the potential retroactive disqualification of REITs under § 856(m)(2)(C). One alternative would be to treat securities held by the REIT (or a successor under § 381) on or prior to October 22, 2004, that qualified as "straight debt" as continuing to qualify for the § 856(m)(1) safe harbor. Another alternative would be to include in any technical corrections legislation a provision so that § 856(m)(2)(C) would apply only to taxable years beginning after October 22, 2004. We note that this is the effective date of § 856(m)(3)(B), which is the only other part of § 856(m) that contains rules more restrictive than the original RMA language.

C. Clarification That REIT Savings Provisions Apply to Discoveries of Violations after the Act's Effective Date Regardless of When Errors Occurred

By way of background, § 243(g)(2) of the Act provides that the REIT Savings amendments of § 243(f) apply to "taxable years beginning after the date of enactment of this Act." This language could be interpreted to mean that if, in 2006, a REIT finds a problem relating to 2004 or earlier -- including a problem created by passage of the new Act (such as the ownership of debt securities that were permitted under prior law, but retroactively not permitted by the Act, as discussed above)-- the REIT Savings provisions do not apply and the IRS will be required to grapple with curing such issues without the benefit of the REIT Savings provisions. It also means taxpayers will continue to be required to make public disclosures of technical foot faults that would be covered by the REIT Savings provisions but for this effective date glitch, and the IRS will have to commit disproportionate resources to address minor mistakes.[5]

If not clarified, this technical glitch could result in the statute not applying to many of the REIT technical violations that may surface in the next few years. If so, taxpayers once again could be forced to seek uncertain administrative relief from the IRS, tying up already strained resources, in apparent conflict with the original intent of the legislation.

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[3] Again, it is assumed that the non-safe harbor securities owned by the REIT exceeds 1% of the partnership's outstanding securities after application of the Self-Charged Rule, and the non-safe harbor securities are not issued by a Real Estate Partnership.

[4] The "REIT Savings" provisions of the Act, permitting a REIT to "cure" a REIT test violation in lieu of REIT disqualification, are prospective only.

[5] *See, e.g.*, the private letter rulings cited in footnote 6, *supra*.

To remedy this unanticipated problem, we suggest that the TTCA be amended to provide that the § 243(f) REIT Savings amendments apply to items "discovered in taxable years beginning after the date of enactment of this Act." This change would minimize administrative complexity when compared to the current language that arguably delays application of the new rules and would be consistent with the IRS' desire for statutory guidance to speed resolution when the REIT Savings provisions would apply.

D. Modification of "REIT Savings" Provisions to Extend "Cure" Provisions to REITs that Incur a *"De Minimis"* Violation of Certain REIT Asset Tests

1. "REIT Savings" Provisions Allow REITs to "Cure" and/or Pay Monetary Penalties for REIT Test Violations in Lieu of REIT Disqualification

A REIT that fails to satisfy certain REIT asset tests at the end of each calendar quarter loses REIT status. Specifically, a REIT may not own more than 10% of the total voting power or 10% of the total value of the outstanding securities of any issuer (the 10% tests); not more than 5% of a REIT's assets may consist of the securities of any one issuer (the 5% test); not more than 20% of the value of a REIT's total assets may be represented by securities of one or more TRSs (the 20% test); at least 75% of the value of the REIT's total assets must consist of certain real estate assets and cash items (the 75% test); and not more than 25% of the value of a REIT's assets may be represented by "securities" (the 25% test).

As set forth below, the Act provides procedures, and in certain cases, monetary penalties for non-intentional violations of the REIT tax rules. These provisions are intended to relieve both the REITs and the IRS from the burden of seeking IRS approval for minor "foot faults". Although the IRS properly was flexible in retroactively correcting these *de minimis* and inadvertent failures,[6] in at least one case a secondary offering was postponed because technically a company lost its REIT status until the IRS issued retroactive relief under Treas. Reg. §301.9100-1 to allow the REIT to elect to treat a corporation as a TRS.

a. *De Minimis* Violations of the 5% and 10% Asset Tests

Under the Act, a REIT will not lose its REIT status for failing to satisfy the requirements of the 5% and 10% test if the failure is due to the ownership of assets the total value of which does not exceed the lesser of: (i) 1% of the total value of the REIT's assets at the end of the quarter for which such measurement is done; or, (ii) $10 million. However, in either scenario, the REIT must dispose of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such other time period prescribed by the Treasury), or otherwise meet the requirements of those rules by the end of such time period.

[6] In 2004, the IRS issued over ten private letter rulings allowing REITs additional time to elect to treat a company as a taxable REIT subsidiary in order to avoid an asset test violation. *See* PLRs 200451028, 200450013, 200442018, 200440018, 200433008, 200433005, 200433003, 200429002, 200428006, 200422021, 200419010 and 200403005.

b. Non *De Minimis* Violations of the 5% and 10% Asset Tests, the 75% Test and Other Asset Tests

Also under the Act, if a REIT fails to meet **any** of the asset test requirements for a particular quarter and the failure exceeds the *de minimis* standard above, then the REIT still will be considered to have satisfied these tests if the REIT takes a number of curative actions, including paying a penalty and remedying the failure.

2. *De Minimis* Violations of 20%, 25% and 75% Asset Tests

The Act could be interpreted to mean that there are no "cure" provisions in the Act for *de minimis* violations of the 20%, 25%, or 75% asset tests. Accordingly, a REIT that violated one of these provisions in a major way would have the opportunity to cure the violation and pay a penalty, while a REIT that violated one of these provisions in a minor way could face REIT disqualification.

3. Proposed Solution

We propose amending § 856(c)(7)(B)(i), as enacted by the Jobs Act, to read: "such failure involves the ownership of assets to which subparagraph (A) does not apply at the end of the calendar quarter for which such measurement is done". We believe that this change is in fact what was intended.

E. Clarification That Expansion of "Determination" Definition for Deficiency Dividends Applies to Determinations, not Errors, after the Act's Effective Date

1. REIT's Identification of Failure to Distribute Relevant Amount Now Constitutes a "Determination"

The deficiency dividend provisions of section 860(a) allow a REIT to pay a "deficiency dividend" in a later year in order to remedy a failure to distribute the correct dividend amount in a prior year resulting from a "determination". Prior to the Act, a "determination" consisted of a Tax Court decision, a closing Agreement, or another agreement signed by the Secretary of the Treasury. The Act amends § 860(e) to allow a REIT's unilateral identification of a distribution error to be considered a "determination". This provision applies to taxable years beginning after date of enactment.

2. Issue

Some practitioners have raised with us the issue of whether revised § 860(e) applies to determinations made in taxable years after the date of enactment (thus, the distribution errors may have occurred prior to date of enactment) or to distribution errors after the date of enactment. Because § 860(e) applies to a "determination with respect to any [REIT that] results in any adjustment for **any taxable year** . . ." (emphasis added), it would seem that the expansion by the Act to § 860(e) applies to determinations made in taxable years after the Act's date of enactment. Nevertheless, to provide certainty, it would be helpful if this understanding were made clear.

3. Proposed Solution: Clarify That Revised § 860(e) Applies to "Determinations" Made in Taxable Years After Date of Enactment

NAREIT urges that any technical corrections legislation include a provision that clarifies that the change to § 860(e) applies to determinations made in taxable years beginning after date of enactment.

F. FIRPTA Changes

1. REIT Capital Gain Distributions

Under § 897 of the Code, gain or loss of a foreign person from the disposition of a U.S. real property interest (USRPI) is taken into account for U.S. tax purposes as though such gain or loss were effectively connected (effectively connected income, or ECI) with a U.S. trade or business during the taxable year. Foreign persons that realize such gain or loss must file a U.S. tax return. For these purposes, prior to the Act, the receipt of a distribution from a REIT was treated as a disposition of a USRPI to the extent it was attributable to a sale or exchange of a USRPI by the REIT. These capital gain distributions from REIT generally were subject to a 35% withholding tax, and the recipients of such distributions were required to file a U.S. income tax return.

The Act removes a REIT capital gain distribution from treatment as ECI for a foreign investor if the distribution is with respect to stock that is publicly traded on a U.S. exchange and the foreign investor owns less than 5% of the class of stock at any time during the taxable year when such distribution is made. The change applies for taxable years after date of enactment.

2. Issues

The first issue relates to whether the FIRPTA change applies to the recipient shareholder's taxable year beginning after the date of enactment or the REIT's taxable year beginning after the date of enactment. Almost all REITs are calendar year taxpayers, but shareholders may be fiscal year taxpayers. For example, a calendar year REIT might make a capital gain distribution on December 15, 2004 (after the Act's enactment) to a fiscal year shareholder whose taxable year begins December 1st. It is not clear whether the new provision would apply to this distribution.

The second issue relates to the calculation of whether the REIT's shareholder owned more than 5% of that class of the REIT's stock "at any time during the taxable year." Most publicly traded REITs already track those shareholders that own in excess of 5% of their stock for purposes of the REIT ownership rules by monitoring the filings of Schedules 13D and 13G with the Securities and Exchange Commission on an annual basis. Requiring these REITs to use a different twelve month period for tracking purposes would create significant confusion.

3. Proposed Solutions

Regarding the first issue, the TTCA 2004 would provide that the Act's changes to § 897 apply to any distributions by a REIT that are treated as deductions by such REIT with respect to any taxable year after the Act's date of enactment. This change would provide better administrative certainty both to REITs and other withholding agents.

Specifically, § 2(a)(6)(B) of H.R. 5395 would apply the REIT FIRPTA change to "any distribution by a [REIT] which is treated as a deduction for a taxable year of such [REIT] beginning after the date of enactment of [H.R. 5395]." While this provision provides additional clarity and generally is appropriate and useful, it raises the issue of whether a foreign shareholder that receives a deficiency dividend paid by a REIT in a year subsequent to the Act (*e.g.,* 2006) that relates to a year prior to the Act (*e.g.*, 2003) would be subject to 35% withholding tax and the requirement to file a tax return under pre-Act law. A deficiency dividend paid with respect to an earlier year is deductible in that earlier year.[7] NAREIT believes that the new FIRPTA REIT rule should apply to any capital gains distributions a REIT makes as part of a deficiency dividend made in taxable years beginning after October 22, 2004. Although listed REITs rarely make deficiency dividends, without this change outside counsel could not provide "clean" opinions to non-U.S. shareholders that any REIT capital gains distributions they receive in the future would not be subject to FIRPTA. TTCA 2004 does not include this change.

Second, in order to avoid confusion in monitoring their greater than 5% shareholders, it would be helpful if the Act's change to § 897 were modified to apply to any REIT shareholder that owned more than 5% of that class of the REIT's stock by reference to the distributing REIT's taxable year.

NAREIT thanks the Committee for the opportunity to comment on this important legislation.

[7] § 860(a).