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National Policy Bulletin

National Association of Real Estate Investment Trusts®
REITs: Building Dividends and Diversification®

REIT TAX LEGISLATION ADVANCES IN CONGRESS

Executive Summary

On April 9, 2008, the House Ways and Means Committee approved by a 35-5 vote H.R. 5720, the Housing Assistance Tax Act of 2008, that contains virtually all of H.R. 1147 and S. 2002, the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA) that NAREIT has strongly supported. H.R. 5720 contains several provisions designed to benefit the housing industry, such as tax relief to first-time home-buyers, a standard deduction for property taxes and improvements to the low income housing credit rules. The approximate $11 billion in tax relief is fully offset with revenue-raising provisions. CLICK HERE to read the statutory language of H.R. 5720 and CLICK HERE for a detailed description of H.R. 5720.

NAREIT applauds the Ways and Means Committee for including the RIDEA provisions as part of a larger bill that addresses a number of issues facing the real estate industry. CLICK HERE to read NAREIT's letter in support of H.R. 5720.

On April 10, 2008, the Senate approved by a vote of 84 to 12 H.R. 3221, the Foreclosure Prevention Act of 2008 that contains the same RIDEA provisions as H.R. 5720 except that those provisions would "sunset" after five years, the Senate bill excludes the title in RIDEA on foreign currency gains and the Senate bill clarifies that a taxable REIT subsidiary may be considered an employer at lodging or health care facilities in certain circumstances.

Discussion of RIDEA Provisions in H.R. 5720

H.R. 1147 was introduced on February 16, 2007 by Reps. Joe Crowley (D-NY) and Eric Cantor (R-VA) and now is co-sponsored by thirty four Members of Congress, including more than 80 percent of the House Ways and Means Committee. S. 2002 was introduced on August 3, 2007 as a companion bill by Senators Orrin Hatch (R-UT) and Ken Salazar (D-CO) and is now co-sponsored by 10 Senators, all but one of whom is on the Senate Finance Committee.


Senators Orrin Hatch (R-UT) & Ken Salazar (D-CO)

1. Dealer Sales Safe Harbor

Background

A REIT is subject to a 100 percent tax on net income from sales of property in the ordinary course of business (prohibited transactions or dealer sales). Because of the severity of the 100 percent tax, in 1976 Congress created a safe harbor exception for rental property so that a sale may avoid being classified as a prohibited transaction if it meets certain specific requirements. One of these

1875 I Street, NW, Suite 600, Washington, D.C. 20006-5413 • 202-739-9400, 800-3NAREIT • 202-739-9401 fax
www.nareit.com • www.investinreits.com

requirements is that a REIT does not make more than seven sales of property during the year, or that the aggregate tax bases of all properties sold during the year do not exceed 10 percent of the aggregate tax bases of all of the REIT's properties as of the beginning of the year. Another requirement is that sales of property by a REIT falling under the safe harbor must have been held for at least four years.

By using a figure of 10 percent of the aggregate tax base, the law may penalize companies that are the least likely to have engaged in "dealer" activity. The most established REITs have typically held their properties the longest, resulting in low adjusted bases due to depreciation deductions. This result is inconsistent with

Congress' desire to ensure that REITs own and operate property for investment purposes, but are free to engage in non-dealer market sales to benefit their shareholders. Further, a four-year holding period requirement unnecessarily restricts a REIT's ability to sell its investment properties at the most appropriate time, especially in light of the increased pace of commercial real estate sales in recent years.

H.R. 5720

The safe harbor would be improved by allowing a REIT to select on an annual basis **either** a "fair market value" measurement **or** the current "aggregate bases" requirement. Note that H.R. 1147 would have required a fair value test, but S. 2002 and the Ways and Means bill would permit a REIT to choose each year which method to adopt — presumably the one that allows more sales.

In addition, H.R. 5720 would cut in half the current four-year holding period in the dealer sale safe harbor. We note that this two-year holding period is more than twice the length of time required for long-term capital gain treatment and is consistent with many other investment-oriented Code sections using a two-year period.

The effective date for both safe harbor changes would be for transactions closing after the date of enactment.

2. Raising Taxable REIT Subsidiary Limit

Background

As originally introduced in 1999, the REIT Modernization Act (RMA) limited a REIT's ownership in taxable REIT subsidiaries (TRSs) to 25 percent of the REIT's gross assets. The 25 percent limit was used when Congress first passed the RMA in a bill that was later vetoed by then-President Clinton for reasons unrelated to the RMA, but it was reduced to 20 percent when it was included in later legislation that was signed into law. The dividing line for testing a concentration on commercial real estate in the REIT rules has long been set at 25 percent. In addition, mutual funds are subject to a similar rule that employs a 25 percent test.

H.R. 5720

The TRS rule would be changed to conform to these 25 percent standards, effective for taxable years beginning after the date of enactment.

3. Conformity of Treatment of Health Care Facilities to Lodging Facilities

Background

As part of the RMA, a lodging REIT may establish a TRS that can lease lodging facilities from a REIT holding a controlling interest, with the payments to the REIT considered qualified income under the REIT rules. A TRS may not operate or manage either lodging or health care facilities.

H.R. 5720

Effective for taxable years beginning after the date of enactment, REITs owning health care facilities, such as assisted living nursing homes, could use the same TRS rules as lodging REITs. Thus, payments collected by a REIT from its TRS for renting health care facilities would be qualified income under the REIT tests. The prohibition of a TRS operating or managing lodging and health care facilities would continue.

4. Permissible REIT Investment Income

Background

In general, federal tax law requires that REITs meet specific tests regarding the composition of their gross income and assets. Specifically, 95 percent of their annual gross income must be from specified sources such as dividends, interests and rents, and 75 percent of their gross income must be from real estate related sources.

Issue

Certain types of income that are typically generated in the commercial real estate business are not mentioned specifically in the 95 percent or 75 percent baskets. Accordingly, if a REIT were to earn a substantial amount of these types of income, the REIT could jeopardize its REIT status – even though these types of income may be directly attributable to the REIT's business of owning and operating commercial real estate. Examples include: foreign currency gains attributable to a REIT's overseas real estate investments, amounts attributable to recoveries in settlement of litigation and "break up fees" attributable to a failure to consummate a merger with another REIT.

H.R. 5720

Foreign currency gains a REIT derives with respect to its business of investing in "real estate assets" would be considered qualifying income under the REIT tests. This bill would confirm the conclusion reached by the IRS in Revenue Ruling 2007-33 and Notice 2007-42 that most foreign currency gains a REIT recognizes from operating its real estate business qualify as "good income" under the REIT income tests, but this RIDEA provision would use a more direct and comprehensive approach and also conform other REIT rules such as the asset tests. Further, under H.R. 5720 the IRS would have the authority to determine whether any item of income not specifically listed in the REIT gross income tests should either be qualified income or not taken into account in determining those tests.

These changes would be effective for taxable years beginning after the date of enactment.

5. The One That Got Away

Largely for budgetary reasons, H.R. 5720 did not adopt the provision in RIDEA that would have allowed a U.S. REIT to treat an investment in a foreign REIT as a qualifying real estate asset under certain conditions.

RIDEA Provisions in H.R. 3221 As Passed by the Senate

As passed by the Senate on April 10, 2008, H.R. 3221, the Foreclosure Prevention Act of 2008, would provide tax relief to homeowners and others as well as reform the Federal Housing Administration.

H.R. 3221 contains the same RIDEA provisions as H.R. 5720 as passed by the House Ways and Means Committee with the following exceptions. First, the provisions would "sunset" after five years. Second, the Senate bill excludes the title on foreign currency gains and the delegation of authority to the IRS to determine which items are qualified REIT income. And, third, statutory language was added to clarify that a taxable REIT subsidiary (TRS) operating outside the United States could be considered an employer of lodging or health care facilities employees without violating the prohibition against a TRS operating or managing a lodging or health care facility. This would be allowed so long as the employees are under the daily supervision and direction by an eligible independent contractor.

Outlook

Before H.R. 5720 goes to the House Floor, it appears that the House Leadership will wait for the House Financial Services Committee to approve a bill that would permit the Federal Housing Administration to underwrite up to $300 billion in loans for borrowers who can not meet the obligations of their current mortgages.

A combined bill then would have to be reconciled with H.R. 3221 as passed by the Senate. A major difference between the Ways and Means Committee and Senate approaches is that the former bill is revenue neutral whereas H.R. 3221 is not offset with revenue raisers. Further, the White House has indicated that it does not support the Senate bill. Accordingly, the extent to which the House and Senate bills could be reconciled or whether the President would veto the resulting product is not clear.

NAREIT will continue working with policymakers to attempt to include the RIDEA provisions in the housing bill or other legislation that will pass this year.

For further information, please contact Tony Edwards at tedwards@nareit.com or Dara Bernstein at dbernstein@nareit.com.