February 23, 2007

National Policy Bulletin

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

EXECUTIVE SUMMARY

On Feb. 16, 2007 Reps. Joseph Crowley (D-NY), Eric Cantor (R-VA), Earl Pomeroy (D-ND) and Thomas Reynolds (R-NY) introduced H.R. 1147, the REIT Investment Diversification and Empowerment Act (RIDEA). CLICK HERE to read Rep. Crowley's introductory remarks and the statutory language. The bill is substantially similar to S. 4030 that Senator Hatch (R-UT) introduced in the last session of Congress.

Under this legislation:

1) foreign exchange gains that a REIT generates from operating real estate outside of the United States generally would qualify under both REIT gross income tests;

2) the limit on a REIT's ownership of taxable REIT subsidiaries (TRSs) would increase from 20% to 25% of the REIT's gross assets;

3) the safe harbor test for dealer sales would change by reducing the holding period requirement from four years to two years and by measuring the 10% sales test by fair market value instead of tax basis;

4) health care facilities could be leased by a TRS to a REIT under the same rules that currently apply to lodging facilities; and,

5) a U.S. REIT could own stock of a foreign REIT under the same rules that apply to ownership of stock in another U.S. REIT, so long as the foreign REIT is organized in a country with REIT tests similar to the United States.

OUTLOOK

NAREIT expects that a Senate counterpart to H.R. 1147 will be introduced in March 2007. NAREIT intends to work with the sponsors of RIDEA to build bipartisan support for the legislation and maximize the chance of adding it to a tax bill that will be enacted this year. RIDEA is endorsed by The Real Estate Roundtable.

DETAILED SUMMARY OF H.R. 1147

Permissible REIT Investment Income

Background

In general, federal tax law requires that a REIT meet specific tests regarding the composition of its gross income and assets. Specifically, 95% of its annual gross income must be from specified sources such as rents, dividends and interest, and 75% of its gross income must be just from real estate related sources. Similarly, at the end of each calendar quarter, 75% of a REIT's assets must consist of specified "real estate" assets. Consequently, REITs must derive a majority of their gross income from the investment real estate business.

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Failure to meet these tests can result in loss of REIT status, although with the enactment of the REIT Improvement Act in 2004, it may be possible for a REIT to pay a monetary penalty and bring itself into compliance in order to avoid such a result if the REIT can demonstrate reasonable cause for such failure.

Issue

Questions have arisen because certain types of income are not mentioned specifically in the 95% or 75% gross income baskets discussed above, and, accordingly, if the 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 investment 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.

In a number of cases, the IRS has issued a private letter ruling to a specific taxpayer holding that the particular type of income should be considered either qualifying income or should be ignored for purposes of the REIT rules.[1] Unfortunately, these rulings cannot be relied on by other taxpayers and in any event do not cover all circumstances.

In addition, the IRS has issued several private letter rulings[2] that partly address the foreign currency issue through the complicated and burdensome use of "subsidiary REITs".

NAREIT believes that the Treasury Department has regulatory authority to issue broad guidance regarding a REIT's recognition of foreign currency gains, but officials have been reluctant to do so because they are not confident that they have sufficient authority.

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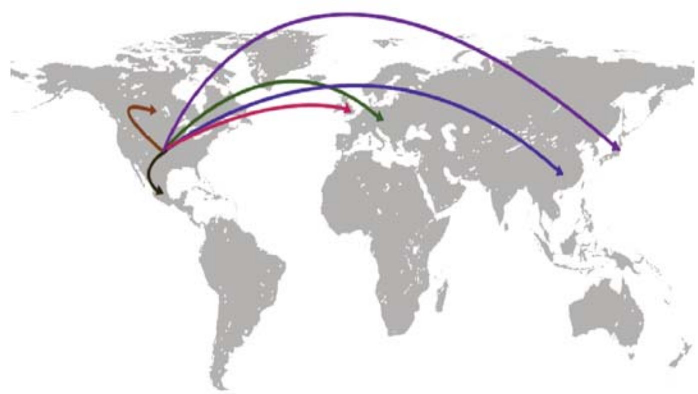
RIDEA would: 1) characterize foreign currency gains attributable to a REIT's ownership and operation of overseas real estate assets as qualifying income under the 75% and 95% gross income tests; 2) conform the current REIT hedging rule to also apply to foreign currency gains and to apply those rules for purposes of the 75% gross income test as well as the 95% gross income test under current law; 3) expressly provide the Department of the Treasury the authority to issue guidance on other items of income to either qualify under the 75% and 95% gross income tests or to provide that items of income are not taken into account in computing those tests; 4) treat foreign currency as cash or cash items for purposes of the REIT asset tests; and, 5) make conforming changes to other REIT provisions reflecting foreign currency gains.

Note that Rep. Crowley's introductory remarks state that he expects the IRS to use these provisions to issue guidance concluding that dividend-like income items, such as Subpart F income and income derived from an investment in a passive foreign investment company, to either be considered qualifying REIT income or income that is not taken into account for purposes of the gross income tests.



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% of the REIT's gross assets. The 25% limit was retained when Congress first passed the RMA as part of another bill later vetoed by President Clinton for reasons unrelated to the RMA. However, the limit was reduced to 20% when Congress enacted the RMA as part of the Ticket to Work Incentives Improvement Act of 1999.

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RIDEA would increase the limit on TRS ownership to 25% of gross assets, as originally contemplated in the RMA. The rationale for a 25% limit remains the same today. The dividing line for testing a concentration on investment real estate in the REIT rules has long been set at 25%. Notably, the mutual fund rules continue to use a 25% test.

Prohibited Transaction Safe Harbors (Dealer Sales)

Background

A REIT may be subject to a 100% tax on net income from sales of property in the ordinary course of business ("prohibited transactions" or "dealer sales"). In 1978, Congress recognized the need for a bright line safe harbor test for determining whether a REIT's property sale constituted a prohibited transaction. Congress further liberalized these rules in 1986 to better comport with industry practice and to simplify a REIT's ability to sell investment property without fear of being taxed at a 100% rate. The current safe harbor exception for rental property provides that a sale may avoid being classified as a prohibited transaction if it meets all of the following requirements:

1) the REIT holds the property for at least four years;

2) capital improvements that the REIT made to the property during the preceding four years do not exceed 30% of the property's selling price;

3) (a) the REIT does not make more than seven sales of property during the year, or (b) the aggregate bases of all properties sold during the year do not exceed 10% of the aggregate tax bases of all of the REIT's properties as of the beginning of the year; and,

4) in the case of property not acquired through foreclosure or lease termination, the REIT held the property for the production of income for at least four years.

As part of the Jobs Creation Act of 2004, similar rules were established for the sale of timberland.

Holding Period. Because of the growth of the REIT industry, in combination with the fact that investment real estate has been increasingly recognized as a separate asset class that provides substantial diversification and performance benefits for investors, the real estate market has achieved greater levels of liquidity than ever before. This increased liquidity has provided real estate owners who have invested for the long term with more and more appropriate opportunities to maximize value by selling assets far sooner than past practice dictated. REITs that rely on the safe harbor have been precluded from selling some of their investment assets

at the most appropriate time because of the current four-year requirement, which has been in place for almost 30 years.

The safe harbor is intended to provide a clear dividing line between a REIT acting as an investor as opposed to a dealer. However, the four-year requirement is arbitrary and not consistent with other code provisions that define whether property is held for long-term investments, *e.g.*, the one-year holding period to determine long-term capital gains treatment, and the two-year holding period to distinguish whether the sale of a home is taxable because it is held for investment purposes. NAREIT believes it is appropriate to reduce the dealer safe harbor test holding period from four years to two years. This approach is consistent with the tax code's use of a two-year holding period in many other areas to denote investment intent.[3]

Measurement of 10% of a REIT's Portfolio. Because of condition 3, many REITs cannot use the safe harbor; as a result, these companies' ability to responsibly manage their property portfolio is impeded. Condition 3(a) is unavailable because many REITs own well in excess of 100 properties, and interests in partnerships may significantly increase the number of properties that the REIT may own and sell in a year. For these REITs, the "seven sales per year" option cannot be used.

In addition, condition 3(b), relating to aggregate tax bases, penalizes 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 or amortization deductions. Thus, the aggregate bases of all the REIT's properties will be relatively much lower for purposes of the safe harbor exception than for a REIT that routinely turns over its properties every four years. Accordingly, a REIT that holds its properties for the longer term may be penalized.

As part of the REIT Modernization Act of 1999, Congress adopted a provision that utilizes fair market value rules for purposes of calculating personal property rents associated with the rental of real property. Thus, there is a close precedent for a fair value approach.

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RIDEA would change the dealer sales safe harbors by: 1) reducing the holding period requirement from four years to two years; and, 2) substituting a "fair market value" measurement in condition 3(b) above for the current "aggregate bases" requirement. Thus, a REIT could satisfy the safe harbor so long as the aggregate <u>fair market value</u> of property sold during the taxable year did not exceed 10% of the <u>fair market value</u> of all of its assets as of the beginning of the taxable year.

Conforming the Treatment of Health Care Facilities to Lodging Facilities

Background

Generally, payments made from a subsidiary owned by a REIT to that REIT are not considered qualified income for REIT purposes under the "related party rules." However, as part of the

REIT Modernization Act of 1999 (RMA), a lodging REIT is allowed to establish a taxable REIT subsidiary (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. The RMA also created a rule under which a TRS is not allowed to operate or manage lodging or health care facilities.

At the time the RMA was considered health care REITs did not request the treatment sought by lodging REITs, so health care facilities today do not qualify for the RMA exception to the related party rules. At the present time, many operators of health care assets, such as assisted living facilities, prefer not to bear the lessee's financial risk and would rather act purely as an independent operator of the facilities. Most health care REITs now believe that the TRS restriction interferes with their ability to oversee their property ownership interests in the most efficient manner.

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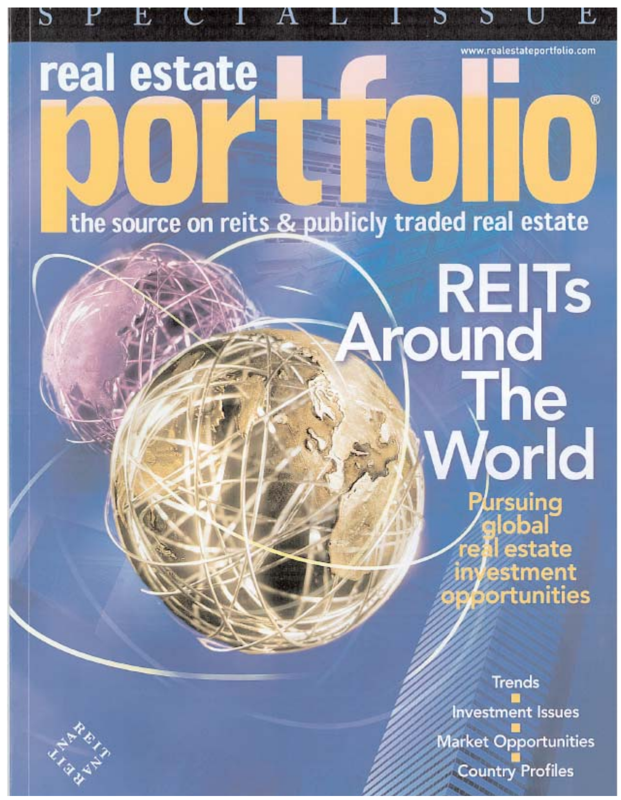
RIDEA would create a rule for health care facilities that completely parallels the rule applying to lodging facilities, *i.e.*, a TRS would be required to use an independent contractor to manage or operate health care facilities, but payments collected by a REIT from its TRS in connection with renting health care facilities would be qualified income under the REIT tests.

Relative to S. 4030, H.R. 1147 clarifies that the mere possession by a TRS of a license to operate a health care or lodging facility does not violate *per se* the prohibition on operating such facilities, so long as an independent contractor in fact operates the facility. For example, a TRS would not be deemed the operator of a lodging facility if the TRS merely obtains a liquor license for a restaurant on the premises that is operated by an independent contractor.

Foreign REITs

Background

The number of countries that have adopted REIT-like legislation this past decade has greatly grown. Especially notable, U.K. REITs came alive on Jan. 1, with Germany and Italy expected to follow suit in the next several months. Although the tax code treats stock in a U.S. REIT as a real estate asset (so that it is a qualified asset that generates qualifying income), current law does not afford the same treatment to the stock of non-U.S. REITs.



In the future, a U.S. REIT may decide to invest in another country through a REIT organized in that country. Under current rules, a company could lose its status as a U.S. REIT if it owns more than 10% of the foreign REIT's securities, even though the foreign company looks and acts like a U.S. REIT. NAREIT believes that a U.S. REIT should not be discouraged from investing in an entity that engages in the same activities that a U.S. REIT is allowed to undertake if it invests directly in another country.

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RIDEA would treat stock in a listed foreign REIT as real estate for purposes of the U.S. REIT tests if under the rules and practices of another country: 1) at least 75% of the company's assets must be invested in real estate assets; 2) the non-U.S. REIT either receives a dividends paid deduction or is exempt from corporate level tax; and, 3) the non-U.S. REIT is required to distribute at least 85% of its taxable income to shareholders on an annual basis.

The newly introduced version of RIDEA makes two changes to the S. 4030 version. First, H.R. 1147 directs the IRS to take into account non-statutory requirements (such as stock exchange listing rules) and market practices in determining whether a jurisdiction's REIT rules satisfy the "Qualified Foreign REIT" tests. For example, if a country's REIT rules only require a REIT to own 50% of its assets as real estate, but the listed REITs in that country average 90% in real estate assets, then the IRS is to conclude that the jurisdiction satisfies the 75% asset test for a Qualified Foreign REIT. Second, H.R. 1147 provides the IRS with express authority to withhold Qualified Foreign REIT designation from a jurisdiction it believes provides too much potential for a foreign REIT to earn excessive non-real estate income that would be inconsistent with the spirit of the U.S. REIT 75% income test.

Effective Dates

The general effective date for H.R. 1147 is taxable years beginning after the date of enactment. However, H.R. 1147 accelerates some of the effective dates to apply to transactions entered into after the date of enactment, *e.g.*, dispositions tested under the dealer sales rules.

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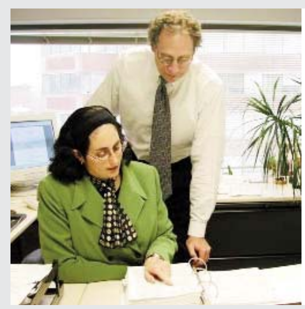

[1] *See, e.g.*, PLRs 200614024 and 200528004 (refunded state tax credits); 200414025 (guarantor substitution payment), 200127024 (merger and acquisition break-up fee); 200115023 (gross income from section 481 adjustment); 200039027 and 9636014 (litigation settlement fees).

[2] *See* PLRs 200550025, 200550017, 200550010, 200519007, 200532015, 200531013, and 200548004.

[3] *See* section 121 (2-year holding period for exclusion on gain from sale of principal residence); section 267 (related party matching income/expense rule does not apply if 2-year holding period met); section 382(c) (NOL carry forwards allowed if 2-year holding period met); section 422 (incentive stock option treatment allowed if stock underlying option held for 2 years after option grant); section 453/1031(f) (related party anti-abuse acceleration of income rule does not apply if 2-year holding period met); section 1031(h)(2) (predominant use of property determined per a 2-year holding period; section 5881 (greenmail tax does not apply if hostile shareholder held corporation's stock for at least 2 years). *Cf.* Treas. Reg. § 1.707-3(a)(1) (disguised sale rules do not apply if 2-year holding period met).