October 25, 2004

national policy
bulletin

National Association of Real Estate Investment Trusts®

INTERNATIONAL TAX REFORM BILL ENACTED CONTAINING SIGNIFICANT REIT CHANGES AND TEMPORARY 15-YEAR LEASEHOLD IMPROVEMENT RECOVERY PERIOD

On October 22, 2004, President Bush signed the export tax reform bill entitled the American Jobs Creation Act of 2004, H.R. 4520, that contains all three titles of the NAREIT-supported REIT Improvement Act of 2003 (RIA), as well as a provision that reduces the recovery period for certain leasehold improvements from 39 to 15 years for second-generation improvements placed in service through 2005.

Although the separate House-passed (also H.R. 4520) and Senate-passed (S. 1637) versions of this legislation together contained the three titles of the RIA, each bill contained separate titles of the RIA. Similarly, the leasehold improvement provision was contained only in the prior House-passed version. NAREIT applauds the decision to include all three titles of the RIA and the leasehold improvement provision in the final legislation. CLICK HERE for the statutory language and Conference Report for H.R. 4520.

RIA PROVISIONS

The three titles of the RIA contained in H.R. 4520 are described in more detail below. First, H.R. 4520 includes Title I of the RIA, which allows, among other things, a REIT to make certain loans in the ordinary course of business without the risk of losing REIT status. These provisions also will allow timber sales to qualify for the safe harbor from the 100% prohibited transactions tax. Second, H.R. 4520 incorporates Title II of the RIA, which will eliminate a substantial barrier to non-U.S.investment in REITs by conforming the treatment of foreign shareholders in publicly traded REITs to that of foreign shareholders in other publicly traded companies. Finally, H.R. 4520 contains Title III of the RIA, which will allow REITs to avoid REIT disqualification for non-intentional REIT test violations either by paying a monetary penalty if the violation is due to reasonable cause or, for certain *de minimis* violations, by bringing themselves into compliance with the REIT rules. For more information on the RIA, CLICK HERE.

Title I of the RIA

Expansion of Straight Debt Safe Harbor

Current law prohibits REITs from owning more than 10% of the value of any other entity's securities other than in a taxable REIT subsidiary (TRS) or another REIT. The prior exception for

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"straight debt" securities did not apply to many situations when individuals and businesses owe some debt to a REIT, including non-abusive loans issued in the ordinary course of business. For example, a REIT that loans a tenant money payable out of cash flow to make leasehold improvements could end up with more than 10% of the tenant's total debt obligations. Even though the total amount of debt might be small, it could have caused the REIT to lose its status.

To solve this problem, H.R. 4520 exempts from the 10% test 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. The "straight debt" clarification generally is effective for taxable years beginning after December 31, 2000 (the effective date of the REIT Modernization Act provisions enacted in 1999).

Clarification of Limited Rental Exception

Current law contains several rules to prevent a REIT from shifting income out of its taxable subsidiary to the REIT (which is subject to only one level of tax). For example, rent paid by a TRS to its controlling REIT qualifies as rental income under the REIT tax tests only if at least 90% of the space is rented by unrelated parties and the TRS pays rent comparable to that paid by the unrelated parties. Application of the test was unclear because prior law did not contain a measurement date for determining how much of the REIT's property is rented by unrelated parties or at comparable rates, nor did it address the consequences of lease terminations that have the effect of increasing the percentage of property rented to the subsidiary above 90%.

H.R. 4520 clarifies this by testing the comparability of rents at the beginning of a lease term, upon a lease extension, and upon a lease renegotiation when the rent between a REIT and its subsidiary is increased. It also allows a REIT a full quarter to re-lease space to unrelated parties when a termination causes a REIT to rent more than 10% of a property to a taxable REIT subsidiary. This provision also is effective for taxable years beginning after December 31, 2000.

Deletion of Customary Services Exception

Current law imposes a 100% excise tax on income or deductions improperly shifted between a REIT and its TRS. This excise tax did not apply to income the subsidiary earns that is attributable to services the REIT itself could provide. H.R. 4520 simplifies current law by deleting a safe harbor protection for a TRS providing customary services to a REIT's tenants, while leaving another safe harbor available. This provision is effective for taxable years beginning after October 22, 2004.

Conformity with General Hedging Definition

The tax code provides that any amounts a REIT realizes from any hedge of real estate debt "to reduce interest rate risks" qualifies as good REIT income for purposes of the 95% gross income test. This provision will conform the definition of a hedge to the general Code provision in section 1221, and will disregard any such hedge income in computing the 95% test. This new test will make clear that hedges include a variety of circumstances, *e.g.* currency hedges of mortgage debt. This provision is effective for taxable years beginning after October 22, 2004.

Conformity with Regulated Investment Company Rules

Each year, at least 75% of a REIT's gross income must be from real estate related sources, and at least 95% of its gross income must be from a combination of real estate and passive income sources. REITs failing to satisfy the test can be considered to have met them if the failure was due to reasonable cause. REITs that fail the 75%/95% tests are subject to additional taxes based on the difference between its actual income and the income required to meet the 75% or 95% tests.

In 1999, Congress inadvertently forgave from this tax REITs whose income from real estate and passive sources is more than 90% but less than 95% of total gross income. H.R. 4520 corrects that mistake for taxable years beginning after October 22, 2004.

Timber Safe Harbor from 100% Tax on Dealer Sales

Current law imposes a 100% tax on a REIT's net income from "prohibited transactions," *i.e.*, the disposition of property that is held for sale in the ordinary course of the taxpayer's trade or business. However, the safe harbor from this tax can apply only to property held for at least 4 years for the "production of rental income." Current law prevents timber REITs from using the existing safe harbor because their qualifying REIT income is from the sale of timber, not from the rental of real estate. Nevertheless, timber REITs face the same prohibited transaction rules, and their occasional disposal of real estate in the course of efficiently managing their properties subjects them to considerable uncertainty because the safe harbor is not available to them.

H.R. 4520 solves this problem by broadening the safe harbor to ensure that REITs that hold land for the purpose of selling timber do not trigger the prohibited transactions tax when they sell that land under specified conditions. While the current rule applicable to rental property includes a 30% limit on capital expenditures in the four years prior to the sale of the property, a 5% limit will apply in the case of timber property. This provision applies to taxable years beginning after October 22, 2004.

Title II of the RIA

Modifications to Treatment of Foreign Investors in REITs

Under current law, a foreign investor who receives a REIT capital gain distribution is treated as engaged in a U.S. business under the Foreign Investment in Real Property Tax Act (FIRPTA) provisions of the Internal Revenue Code. Accordingly, the distributing REIT must withhold a 35% tax on the distribution, while the investor is required to file a U.S. tax return and may be required to pay a "branch profits" tax solely because of such distribution.

H.R. 4520 includes a provision that will treat the capital gains distributions of a publicly traded REIT to a non-U.S. investor as ordinary dividends so long as the investor owns 5% or less of the distributing REIT. Consequently, the investor will not be required to file a U.S. tax return, the branch profits tax will not apply, and the distributing REIT will withhold at a 30% rate or a lower rate prescribed by bilateral treaties. This provision will conform tax policy to the general FIRPTA rule for sales of REIT stock and to the tax treaty policy concerning REIT dividends Congress and the Treasury

Department adopted in 1997. CLICK HERE to view the withholding rates broken down by country of shareholder residence as of July 1, 2004. These provisions in H.R. 4520 are effective for taxable years beginning after October 22, 2004.

Title III of the RIA

REIT Savings

There are certain so-called "death trap" provisions in the REIT rules, a violation of which can result in the disqualification of the REIT. Naturally, REIT managers expend significant resources to avoid such a drastic result. H.R. 4520 builds in some flexibility to the REIT tax rules and impose monetary penalties, in lieu of REIT disqualification, for the failure to meet certain REIT rules when reasonable cause for the failure exists.

Asset Test - Under current law, a REIT is disqualified if more than 5% of its assets are comprised of the securities of any entity (other than a TRS or another REIT), or if it owns more than 10% of the voting power or value of any entity (other than a TRS or another REIT). So long as the overage is the result of reasonable cause, H.R. 4520 replaces REIT disqualification with a two-part process. First, the REIT will be given an opportunity to dispose without penalty (within six months) of interests comprising up to 1% of its total assets to get under the 5%/10% tests, or otherwise comply with such tests. Second, assets in excess of the 1% *de minimis* amount will be subject to a tax the greater of $50,000 or the highest corporate tax rate multiplied by the net income from the assets.

Other Tests - Under current law, disqualification occurs when a REIT fails other tests relating to its organizational structure, the distribution of its income, its annual elections to the IRS, the transferability of its shares, etc. In lieu of disqualification, H.R. 4520 instead assesses a monetary penalty of $50,000 for each reasonable cause failure to satisfy these rules. If the violation is intentional, the company will continue to face loss of REIT status.

These provisions in H.R. 4520 are effective for taxable years beginning after October 22, 2004.

LEASEHOLD IMPROVEMENTS

H.R. 4520 also contains a provision that reduces from 39 to 15 years the recovery period for second-generation leasehold improvements placed in service between October 22, 2004 and December 31, 2005. NAREIT, along with many other national real estate organizations, has long sought a permanent reduction in the recovery period for leasehold improvements.

DOMESTICALLY CONTROLLED REITS

Under current law, the FIRPTA provisions of the tax code apply to a sale of REIT stock to a non-U.S. person except when: 1) the REIT is publicly traded and the non-U.S. purchaser owns 5% or less of the REIT; or, (2) less than 50% of the REIT's stock is owned by non-U.S. persons during the testing period. If FIRPTA applies, the foreigner's gain from the sale of REIT stock is treated as generated from a United States trade or business, so that the foreigner must file a U.S. tax return and pay a U.S. tax as if the person was doing business in the U.S.

H.R. 4520 expands the FIRPTA exception for sale of stock of a domestically-controlled REIT to also cover a domestically-controlled mutual fund. The new terminology for both entities is "qualified investment entity." The provision generally takes effect after December 31, 2004.

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