<u>Check-The-Box Rules Facilitate Both Immediate U.S. Taxation of Overseas Income Earned by REITs and Compliance with REIT Rules and Should Be Retained</u>

Background: ***President Obama's Budget Proposes to Treat Certain Foreign "Disregarded Entities" as Corporations***. President Obama's budget includes a proposal to change the tax treatment of many foreign businesses that are owned by U.S. companies by undoing the application of the Clinton Administration "check-the-box" (CTB) regulations as they apply to these foreign subsidiaries.

Current CTB Rules Facilitate Immediate Taxation of REIT Income from Foreign Investments and Compliance with the REIT Rules. A REIT may invest in foreign real estate through a foreign limited liability entity that checks the box to be a disregarded entity (DE) in order to achieve immediate flow-through of foreign income to the REIT so it can maximize distributions to shareholders and comply with the REIT income and asset tests.

Income Tests: At least 75% of a U.S. REIT's annual gross income (75% Basket Income) must be from real estate-related sources, including rents from real property and interest on secured mortgages, and at least 95% of a U.S. REIT's annual gross income (95% Basket Income) must be from the 75% sources, as well as passive income, like non-real estate interest and dividends. Thus, only 5% of a REIT's annual gross income (5% Basket Income) can be from non-real estate, non-passive sources without jeopardizing the REIT's status.

Asset Tests: Among other things, 1) at least 75% of the value of a REIT's assets quarterly must be from "real estate" sources (including foreign real estate); 2), a REIT cannot own more than 10% of the vote or value in a corporation other than another REIT, a "taxable REIT subsidiary" (TRS) or a wholly-REIT owned "qualified REIT subsidiary" (10% Asset Test); and, 3) the value of securities of all TRSs cannot amount to more than 25% of a REIT's assets (TRS Asset Test).

If a REIT-owned foreign entity that checked the box to be a DE were treated as a U.S. corporation for U.S. tax purposes—

- <u>REIT status potentially would be jeopardized</u> -REIT could fail the 10% Asset Test or the 75% Basket Income Test, and, even if the entity were a TRS, it could fail the TRS Asset Test, thereby jeopardizing its REIT status.
- <u>Qualifying real estate income currently subject to immediate taxation converted to – at best –dividend income subject to taxation only when distributed</u>. Income from DE would be converted from active rental income that qualifies as 75% Basket Income that flows through to shareholders to at best 95% Basket Income from DE dividends only when distributed, or at worst, 5% Basket Income if treated as subpart F income. Under current regulations, if DE were a corporation for U.S. tax purposes, its active rental income may be considered subpart F income, and possibly 5% Basket Income because there is no guidance on the character of such income under the REIT Income Tests.

Conclusion: any changes to the CTB rules should not apply to REITs: Ostensibly, the CTB proposal is considered a "loophole closer" to limit deferral of foreign income, but for U.S. REITs, it could have the reverse effect of encouraging deferral. In addition, it could cause difficulties complying with the REIT income and asset tests. Furthermore, the current CTB rules provide simplicity, business efficiencies, and foreign tax reduction for REITs and many other taxpayers. For these reasons, the current CTB rules should not be modified.