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REITs Empowered

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I. INTRODUCTION

On July 30, 2008, as part of a larger bill designed to address the national housing and foreclosure crisis, President Bush signed into law H.R. 3221, the Housing and Economic Recovery Act of 2008 (the Act).¹ The Act contains all but one of the provisions that were contained in H.R. 1147 and S. 2002, the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA).²

NAREIT strongly supported RIDEA and worked closely with policymakers to obtain its passage. Among other things, RIDEA makes “several minor, but important, changes in the REIT tax rules to permit REITs on behalf of their shareholders to continue to compete with

other real estate companies in international and domestic markets.”³

II. EXECUTIVE SUMMARY

The provisions of the Housing and Economic Recovery Act of 2008 affecting real estate investment trusts (REITs) enable REITs to buy and sell assets more effectively, allow REITs to engage in a higher level of entrepreneurial activities through their taxable REIT subsidiaries (TRSs), enable health care REITs to structure their investments similar to hotel REITs following the enactment of the REIT Modernization Act (RMA) in 1999,⁴ and provide certainty concerning the treatment for REIT qualification purposes of operations denominated in foreign currencies from overseas investments and receiving other types of gross income.

III. RIDEA CHRONOLOGY

RIDEA was first introduced as S. 4030 in the 109th Congress on September 29, 2006, by Senator Orrin Hatch (R-UT). Congress took no action on RIDEA in that Congress.

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¹ P.L. 110-289.

² P.L. 110-289, §§3031-3071.

³ 153 Cong. Rec. E384 (Daily Digest, Remarks of Representative Joseph Crowley, Feb. 16, 2007).

⁴ The Ticket to Work and Work Incentives Improvement Act of 1999, P.L. 106-170, §§541-71.

During the 110th Congress, Representative Joe Crowley (D-NY), along with Representatives Eric Cantor (R-VA), Earl Pomeroy (D-SD), and Tom Reynolds (R-NY), re-introduced RIDEA as H.R. 1147 on February 16, 2007, with only minor changes from S. 4030. The re-introduced bill clarified that a TRS is not considered as operating or managing lodging or health care facilities solely because it holds a license, permit or similar instrument enabling it to do so. This clarification was necessary in several circumstances, e.g., when a state requires a landlord or lessee to be the holder of a bar license. H.R. 1147 also: 1) extended to health care facilities the prior law's rule⁵ regarding the ability of an independent contractor to be a sub-franchisee of a REIT or its TRS; 2) required the Treasury Department to take into account stock exchange rules and market practices in deciding whether a foreign REIT regime qualified under the global REIT title of RIDEA; 3) delegated to the Treasury Department anti-abuse authority in the foreign REIT area; and, 4) changed the effective date of certain sections of RIDEA, e.g., dealer sales, to transactions after the date of enactment.

On August 3, 2007, Senator Hatch, along with Senators Ken Salazar (R-CO), Gordon Smith (R-OR) and John Kerry (D-MA), introduced S. 2002, a version of RIDEA virtually identical to H.R. 1147.⁶ Like other recent legislation affecting REITs, the RMA, and more recently, the REIT Improvement Act (RIA),⁷ RIDEA enjoyed wide bipartisan sponsorship. H.R. 1147 ultimately was co-sponsored by over three-fourths of the House Ways and Means Committee, and S. 2002 ultimately was co-sponsored by over half of the Senate Finance Committee.

On April 9, 2008, as part of a larger bill to address the increase in home foreclosures and other housing market issues, the House Ways and Means Committee approved H.R. 5720, the Housing Assistance Tax Act of 2008, by a vote of 35-5, which contained all of RIDEA's provisions (including the choice of tax basis or fair market value in measuring the 10% safe harbor rule) except for the foreign REIT title.

On April 10, 2008, the full Senate approved H.R. 3221, the Foreclosure Prevention Act of 2008, by a

vote of 84-12. H.R. 3221 contained the same RIDEA provisions as H.R. 5720 when approved by the House Ways and Means Committee, except that: 1) the provisions would have expired after five years; 2) the title of RIDEA relating to foreign currency and delegating to the Treasury Department authority to categorize qualifying and non-qualifying REIT income was omitted; and, 3) a provision was added clarifying that TRSs could employ workers at certain health care and lodging facilities located outside the U.S. so long as an eligible independent contractor is responsible to supervise and direct these workers on behalf of the TRS.

On May 8, 2008, the House of Representatives passed H.R. 3221, a comprehensive housing bill to address the housing foreclosure crisis through tax measures and reforms to the Federal Housing Administration (FHA). The bill included the same provisions of RIDEA that were adopted by the House Ways and Means Committee on April 9 when it passed H.R. 5720. H.R. 5720 was incorporated into H.R. 3221 before it passed the House by a vote of 322-94.

On July 11, 2008, the Senate passed H.R. 3221, the Housing and Economic Recovery Act of 2008, by a vote of 63-5. With two exceptions, the bill included the same provisions contained in RIDEA that were adopted by the House of Representatives on May 8 when it passed its version of H.R. 3221. Thus, this bill included Title I of RIDEA (relating to foreign currency).⁸ Unlike the earlier Senate version of the housing bill, the RIDEA provisions included in the July 11, 2008 version were permanent. Additionally, the Senate bill included the provisions originally included in the version of H.R. 3221 it adopted on April 10, 2008, allowing TRSs to employ workers at health care and lodging facilities located outside the United States, as discussed above.

On July 23, 2008, the House passed virtually the same version of H.R. 3221 as passed by the Senate on July 11, 2008, by a vote of 272-152. The House amended the provisions in the legislation unrelated to RIDEA on July 23, 2008. On July 26, 2008, the Senate voted 72-13 to concur in the House amendment. President Bush signed H.R. 3221 on July 30, 2008.

The general effective date for the Housing and Economic Recovery Act's REIT provisions is taxable

⁵ §856(l)(3) (flush language). Unless otherwise indicated, "section" or "§" refers to a section of the Internal Revenue Code of 1986, as amended (the "Code").

⁶ The only change between S. 2002 and H.R. 1147 was in connection with the measurement of the 10% of sales permitted under the prohibited transactions safe harbor test of §857(b)(6)(C) and (D). H.R. 1147 would have determined this metric based solely on a comparison of relative fair market values. S. 2002 would determine the metric based on either a comparison of relative fair market values or the prior measurement, relative tax bases (at the REIT's annual option).

⁷ The RIA was included in the American Jobs Creation Act of 2004, P.L. 108-357.

⁸ When originally introduced, RIDEA would have treated this type of income as qualifying REIT income under §856(c)(2) and (3). When the Senate passed H.R. 3221, the 2008 Housing and Economic Recovery Act of 2008, on July 11, 2008, which included the first four titles of RIDEA, Title I was amended so that this type of income was excluded from the calculation of qualifying income. This change was made because the staff of the Joint Tax Committee believed such treatment would be more appropriate from a tax policy perspective.

years beginning after the date of enactment, July 30, 2008. However, as further discussed below, the Act 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 safe harbor rules.

IV. RIDEA DETAILED ANALYSIS

A. Prohibited Transaction Safe Harbors (Dealer Sales)

1. Background

A REIT may be subject to a 100% “prohibited transactions” or “dealer sales” tax on net income from sales of property held primarily for sale to customers in the ordinary course of business.⁹ In 1978, Congress recognized the need for a bright line safe harbor test to determine whether a REIT’s property sale constituted a prohibited transaction.¹⁰ Congress further liberalized these rules in 1986 to comport better with industry practice and to simplify a REIT’s ability to sell investment property without fear of being taxed at a 100% rate.¹¹ The pre-Act safe harbor exception for rental property in §857(b)(6)(C) provided that a sale may avoid being classified as a prohibited transaction if it met all of the following requirements:

- 1) the REIT held the property for at least four years;
- 2) capital improvements that the REIT made to the property during the preceding four years did not exceed 30% of the property’s selling price;
- 3) (a) the REIT did not make more than seven sales of property during the year, or (b) the aggregate tax bases of all properties sold during the year did not exceed 10% of the aggregate tax bases of all of the REIT’s properties as of the beginning of the year (10% Rule);
- 4) in the case of property not acquired through foreclosure or lease termination, the REIT held the property for the production of rental income for at least four years;¹² and
- 5) if the REIT was relying on the 10% Rule, all of the marketing expenditures were made through an independent contractor, from which the REIT receives no income.

⁹ §857(b)(6)(A).

¹⁰ The Revenue Act of 1978, P.L. 95-600, §363.

¹¹ The Tax Reform Act of 1986, P.L. 99-514, §666(a).

¹² The American Jobs Creation Act of 2004, P.L. 108-357, §321, established similar rules for the sale of timberland in a new §857(b)(6)(D).

NAREIT believed that the holding period and the measurement of the 10% Rule were outdated. As stated by Jeffrey H. Schwartz, NAREIT First Vice Chair and Chairman and CEO of ProLogis, before the Senate Finance Committee on February 28, 2008:

One of [RIDEA’s] provisions would authorize REITs to manage acquisitions and sales of their property portfolios more effectively and efficiently, consistent with their business goals as long-term holders of real estate. Allowing REITs to more readily access and recycle capital through the acquisition and disposition process would serve to enhance the property marketplace, much like removing the ‘lock-in effect’ when capital gain rates have been lowered. REITs, which are largely well-capitalized and conservatively leveraged, would then be in a better position to inject desirable equity from the public markets into the commercial real estate marketplace, providing ballast to this sector at a potentially difficult time.¹³

a. Holding Period

Because of the REIT industry’s growth, in combination with increasing recognition that investment real estate is a separate asset class that provides substantial diversification and performance benefits for investors, until the last year or so, the real estate market had achieved greater levels of liquidity than ever before. This increased liquidity provided real estate owners who had invested for the long term with increased opportunities to maximize value by selling assets far sooner than past practice dictated.

REITs that relied on the safe harbor had been precluded from selling some of their investment assets at the most appropriate time because of the prior four-year requirement, which had been in place for 30 years. Further, the four-year rule created barriers to REITs that considered acquiring portfolios of properties but wanted the flexibility of selling some non-core properties in those portfolios after two years.

The safe harbor was intended to provide a clear dividing line between a REIT acting as an investor as opposed to a dealer. However, the four-year requirement was 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,

¹³ Prepared Statement of Jeffrey H. Schwartz, Chairman and Chief Executive Officer, ProLogis and First Vice-Chair, National Association of Real Estate Investment Trusts, Before the Senate Finance Committee Hearing on “The Real Estate Market: Building a Strong Economy” at 8 (Feb. 28, 2008).

and the two-year holding period to distinguish whether the sale of a home is taxable because it is held for investment purposes.¹⁴

Earlier this year, a special rule applicable to “timber REITs” was enacted as part of the Food, Conservation, and Energy Act of 2008 (also called the Farm Bill).¹⁵ The Farm Bill contained a number of provisions particular to timber REITs, but these provisions generally apply only to taxable years beginning after date of enactment (May 22, 2008) and before May 22, 2009.

In the case of the dealer sales safe harbor, the Farm Bill contained a provision reducing the holding period in §857(b)(6)(D)(i) from four years to two years for sales to a qualified organization as defined in §170(h)(3) for conservation purposes, as defined in §170(h)(1)(C).¹⁶ Similarly, in the case of such sales, the safe harbor limitations in §857(b)(6)(D)(ii) and (iii) on how much may be added, within the four-year period prior to the date of sale, to the aggregate adjusted tax basis of the property, were changed to refer to the two-year period prior to the date of sale.¹⁷ Finally, any gain that is eligible for the timber property safe harbor is considered for all purposes of the Code not to be gain from the sale of property described in §1221(a)(1) (i.e., it is not dealer property, and gain from the sale of such property can qualify for capital gain treatment).¹⁸

b. Measuring 10% of a REIT's Portfolio

Because of the safe harbor's third requirement (either that no more than seven sales are made during the year or the aggregate tax bases of properties sold during the year do not exceed 10% of the aggregate tax bases of all the REIT's properties at the beginning of the year), many REITs were constrained in their use of the safe harbor; as a result, these companies' abil-

ity to responsibly manage their property portfolio was impeded. The “seven sales” requirement was impractical because many REITs own dozens, if not hundreds, of properties, and interests in partnerships may significantly increase the number of properties that the REIT may own and sell in a year.

The alternate requirement relating to aggregate tax bases penalized some companies that were the least likely to have engaged in “dealer” activity. The most established REITs have typically held their properties the longest, resulting in low adjusted tax bases due to depreciation or amortization deductions. Thus, the aggregate tax bases of all the REIT's properties would have been relatively much lower for purposes of the safe harbor exception than for a REIT that routinely turned over its properties every four years. Accordingly, a REIT that held its properties for the longer term would have been penalized by having the more stringent limitation.

As part of the REIT Modernization Act of 1999 (RMA), Congress adopted a provision that utilizes fair market value rules for purposes of calculating personal property rents associated with the rental of real property.¹⁹ Thus, there was a close precedent for a fair value approach.

c. The Act

i. Reduction in Holding Period

The 2008 Housing and Economic Recovery Act changed the dealer sales safe harbors as follows. First, §3051(a)(1) of the Act reduced the pre-Act dealer sales safe harbor holding period requirement from four years to two years for all REITs, including timber REITs.

Second, §3051(a)(2) of the Act modified the pre-Act dealer sales safe harbor limitations in §857(b)(6)(C)(ii) (applicable to non-timber REITs) and §857(b)(6)(D)(ii) and (D)(iii) (applicable to timber REITs) concerning how much may be added, within the four-year period prior to the date of sale, to the aggregate adjusted tax basis of the property. Specifically, §3051(a)(2) of the Act changed the relevant period from four years to two years.

Finally, §3051(a)(3) of the Act modified §857(b)(6)(C)(i) and (D)(i) to emphasize that the dealer sales safe harbor applies to property that both constitutes a “real estate asset (as defined in §856(c)(5)(B))” as in the pre-Act dealer sales safe harbor *and* “which is described in §1221(a)(1).” We understand that the additional language is meant to demonstrate to a non-REIT taxpayer that just because property sales may meet the dealer sales safe harbor applicable to REITs does not mean that their property

¹⁴ See §121 (two-year holding period for exclusion on gain from sale of principal residence), §267(e)(5)(B)(i) (related party matching income/expense rule for partnerships owning low-income housing and their owners does not apply to payments made by such partnerships to certain partners if, among other things, a two-year holding period is met by such partners), §382(c) (net operating loss carryforwards allowed if two-year holding period met), §422(a)(1) (incentive stock option treatment allowed if stock underlying option held for two years after option grant), §453(e)(2)(A)/§1031(f) (related party anti-abuse acceleration of income rule does not apply if two-year holding period met), §1031(h)(2) (predominant use of property determined per a two-year holding period), §5881(b)(1) (greenmail tax does not apply if hostile shareholder held corporation's stock for at least two years). Cf. Regs. §1.707-3(d) (disguised sale rules presumed not to apply to transfers more than two years apart).

¹⁵ P.L. 110-246.

¹⁶ Farm Bill §15315(a).

¹⁷ *Id.*

¹⁸ §856(b)(7)(G), added by Farm Bill §15315(c).

¹⁹ §856(d)(1)(C) (flush language).

is not “dealer property” described in §1221(a)(1).²⁰ The Joint Tax Committee explained as follows:

The provision makes clear that the safe harbor is an exception from the prohibited transaction tax only, and does not cause a gain on a sale that otherwise does not qualify for capital gains treatment (i.e., because it was a sale of property held for sale to customers in the ordinary course of business under §1221(a)(1)) to become a capital gains transaction.²¹

ii. Modification to 10% Rule

The Act also allows a REIT to measure the 10% limit by either continuing to use tax bases or instead a “fair market value” measurement.²² REITs that rely on this 10% test must comply with the additional requirement that substantially all its marketing and development activities are carried out through independent contractors.²³

iii. Effective Date

The Act’s provisions that modified the dealer sales safe harbor apply to sales made after July 30, 2008.²⁴

iv. Interaction with the “Farm Bill”

The Act’s modifications to the dealer sales safe harbor apply both to non-timber and timber REITs. Thus, the Act eliminated the requirement in the Farm Bill²⁵ that timber property under §857(b)(6)(D) must be sold to a §170(h)(3) qualified organization in order to obtain the two-year holding period requirement.²⁶

²⁰ Gains from the sale of “dealer property” are not qualifying income for REITs. Cf. IV, D, 1, a, iv, below.

²¹ Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, the “Housing Assistance Tax Act of 2008,”* (JCX-63-08), July 23, 2008, at 48.

²² 2008 Housing and Economic Recovery Act §3052. See footnote 6 above, describing the original version of RIDEA as mandating the use of relative fair market values to determine satisfaction of the 10% Rule.

²³ §857(b)(6)(C)(v). The “Farm Bill,” discussed above in IV, A, 1, a, and below in IV, A, 1, c, iv, allows the TRSs of timber REITs to provide these activities for a one-year period.

²⁴ 2008 Housing and Economic Recovery Act §3071(d).

²⁵ See IV, A, 1, a, above.

²⁶ See Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, the “Housing Assistance Tax Act of 2008,”* (JCX-63-08), July 23, 2008 at 48. The Joint Committee also noted that “[i]n the case of a sale of timber property that qualifies for the safe harbor under §857(b)(1)(D) [sic], for the one-year period prescribed in the [Farm Bill], such a sale is considered to be a sale of property held for investment or use in a trade or business, and not of property described in §1221(a)(1), for all purposes of Subtitle A of the code, for such one-year period.” *Id.* at 48, fn. 65.

v. Post-RIDEA Legislative Guidance

The legislative history for RIDEA suggests that a REIT’s election to use tax bases or fair market value is done annually when it files its tax return:

Another test under the dealer sales safe harbor restricts the amount of real estate assets a REIT can sell in any taxable year to 10% of its portfolio. Current law measures the 10% level by reference to the REIT’s tax basis in its assets. [S. 2002] instead would measure the 10% level by using fair market value. To allow a REIT to maximize its sales under the safe harbor (and thereby [generate] more economic activity), RIDEA [S. 2002] would allow a REIT to choose either method for any given year. Presumably, the IRS would develop instructions on Form 1120-REIT allowing a REIT to declare which method it selected when it files its tax return for the year in which the sales occur.²⁷

To allow REITs to plan sales and purchases expeditiously, NAREIT submitted a letter to the IRS and Treasury Department on August 13, 2008, requesting that the government clarify the process under which a REIT can choose the tax basis or fair market value method of measuring the 10% test. To provide REITs with the flexibility to maximize sales under the safe harbor, NAREIT noted its support for Senator Hatch’s suggestion that the election between methods be made after the taxable year in which the sales occur. NAREIT suggested the government consider having a REIT simply check the appropriate box to make this election, with the election contained either in Form 1120-REIT or a separate form.

NAREIT also noted that the most immediate regulatory issue facing REITs is how to utilize the new fair market option for sales occurring between July 30 and December 31, 2008. NAREIT suggested that the government issue guidance stating that, so long as a REIT satisfies the 10% test as measured by tax basis for transactions occurring before July 30, a REIT can test its total 2008 transactions by using either tax basis or fair market value. NAREIT believed that this straightforward test would implement Congress’ intent to provide immediate assistance to REITs by allowing them to better manage their property portfolios.

On September 10, 2008, the IRS and Treasury Department released their regulatory Business Plan for the remainder of 2008 and the first half of 2009. One item on this Priority Guidance Plan was described as

²⁷ 153 Cong. Rec. S10932 (Daily Digest, Remarks of Senator Orrin Hatch, Aug. 3, 2007).

“guidance on REITs under of the Housing Assistance Tax Act of 2008” (the tax title of H.R. 3221). NAREIT is pleased that the government has allocated its limited resources to address the REIT issues that NAREIT raised.

B. Raising Taxable REIT Subsidiary Limit

1. Background

As originally introduced in 1999, the RMA limited a REIT's ownership in TRSs to 25% of the REIT's gross assets.²⁸ 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.²⁹ However, the limit was reduced to 20% when Congress enacted the RMA as part of the Ticket to Work Incentives Improvement Act of 1999.

The Farm Bill allowed timber REITs to own securities in a TRS of up to 25% of the REIT's assets.³⁰ This rule applied only for taxable years beginning after May 22, 2008, and before May 22, 2009. A timber REIT is defined as a REIT more than 50% of the value of whose assets consist of real property held in connection with the trade or business of producing timber.³¹

2. The Act

The Act increased the limit on TRS ownership to 25% of gross assets, as originally contemplated in the RMA.³² 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% asset test.³³

²⁸ See S. 1057 and H.R. 1616, introduced in the 106th Congress.

²⁹ Taxpayer Refund and Relief Act of 1999 (vetoed on Sept. 23, 1999).

³⁰ Farm Bill §15314.

³¹ Farm Bill §15313(b), adding §856(c)(5)(I) to the Code.

³² Housing and Economic Recovery Act §3041. The special 25% rule for TRSs of timber REITs is made permanent since timber REITs are treated as other REITs for purposes of these provisions.

³³ §851(b)(3)(B).

C. Conforming the Treatment of Health Care Facilities to Lodging Facilities

1. Background

Generally, rents received by a REIT from a corporation in which the REIT owns 10% or more of the total voting power or total value of the shares of such corporation are not considered “rents from real property” under the so-called “related party rent rules.”³⁴ However, the RMA included an exception to the related party rent rule which generally provides that rents received by a REIT from its taxable REIT subsidiary (TRS) with respect to a qualified lodging facility leased by the REIT to its TRS shall not be treated as related party rent, provided the lodging facility is operated on behalf of the TRS by an eligible independent contractor.³⁵ The RMA also defined a TRS in part by excluding a corporation that directly or indirectly operates or manages a lodging or health care facility.³⁶

At the time the RMA was adopted, health care REITs did not receive the treatment accorded lodging REITs, allowing them to lease their properties to a TRS, and so health care facilities pre-Act did not qualify for the RMA exception to the related party rules. Today, many operators of health care assets, including assisted living operators, prefer not to bear the financial and operating risks of a lessee but instead want to act solely as an independent operator of the facilities. As a result, health care REITs determined that they wanted to be able to structure their operations to include leases to their TRSs.

2. The Act

a. Generally

Section 3061 of the Act created a rule for health care facilities that completely parallels the rule applying to lodging facilities, i.e., a TRS will continue to be required to use an eligible independent contractor to manage or operate health care facilities, but fair market rents collected by a REIT from a lease of a “qualified health care property,” as defined in

³⁴ §856(d)(2)(B).

³⁵ §856(d)(8)(B).

³⁶ §856(l)(3)(A).

§856(e)(6)(D)(i),³⁷ to its TRS will now be qualified rental income under the REIT tests.³⁸

The Act also provided some helpful clarifications of prior law. First, it clarified that a TRS will not be considered to be operating or managing a qualified health care facility or qualified lodging facility merely because the TRS possesses a license enabling it to do so, provided that an eligible independent contractor in fact operates the facility.³⁹ For example, a TRS will not be deemed the operator of a qualified lodging facility if the TRS merely obtains a liquor license for a restaurant on the premises that is operated by an independent contractor.

Second, the Act clarified that a TRS will not violate the prohibition of operating a qualified lodging or health care facility located outside the United States if it employs individuals working at such facility, so long as an eligible independent contractor is responsible for the daily supervision and direction of such individuals on behalf of the TRS pursuant to a management agreement or similar service contract.⁴⁰

b. Effective Dates

These provisions are effective for taxable years beginning after the date of enactment (i.e., July 30, 2008).⁴¹

³⁷ Section 856(e)(6)(D)(i) defines “qualified health care property” as “any real property . . . and any personal property incident to such real property which . . . is a health care facility or . . . is necessary or incidental to the use of a health care facility.” Section 856(e)(6)(D)(ii) defines a “health care facility” as a hospital, nursing facility, assisted living facility, congregate care facility, qualified continuing care facility, or other licensed facility which extends medical or nursing or ancillary services to patients, and which, immediately before the termination, expiration, default, or breach of the lease of or mortgage secured by such facility, was operated by a provider of such services which was eligible for participation in the medicare program under title XVIII of the Social Security Act with respect to such facility. We understand that some practitioners have questioned whether the final clause of §856(e)(6)(D)(ii), requiring eligibility in the medicare program, applies to all types of “health care facilities” (i.e., hospitals, nursing facilities, assisted living facilities, etc.) or only those listed in the final clause of §856(e)(6)(D)(ii) (i.e., any *other* licensed facility which extends medical or nursing or ancillary services to patients). NAREIT believes that the correct interpretation is the latter. Thus, for example, a hospital, nursing facility, or assisted living facility located outside of the U.S., and therefore, which may not be operated by a provider eligible for participation in the medicare program, still may meet the definition of “qualified health care property” that may be leased by a health care REIT to its taxable REIT subsidiary under these new provisions.

³⁸ Revised §856(d)(8)(B).

³⁹ Revised §856(d)(8)(B)(i).

⁴⁰ Revised §856(d)(8)(B)(ii).

⁴¹ 2008 Housing and Economic Recovery Act §3071(a).

D. Foreign Currency Gains and Hedging Income

1. Foreign Currency Gains

a. Relevant REIT Rules

In general, federal tax law requires that a REIT meet specific tests regarding the composition of its gross income and assets, and satisfy a whole host of requirements designed to ensure that it is a long-term investor in mainly real estate-related assets.⁴² Failure to meet the income and asset tests can result in loss of REIT status, although with the enactment of the REIT Improvement Act (RIA) in 2004,⁴³ 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.

i. REIT Income Tests

For example, at least 75% of the gross income of a REIT annually must consist of real-estate-related income, including: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (75% Income).⁴⁴ Additionally, at least 95% of the gross income of a REIT annually must consist of 75% Income and other passive, non-real estate related sources of income, like interest and dividends (95% Income).⁴⁵

ii. REIT Asset Tests

Another category of these statutory tests applicable to REITs is the asset tests described in §856(c)(4) (the Asset Tests). In particular, at the close of each calendar quarter, at least 75% of the value of a REIT's assets must be represented by real estate assets, cash and cash items (including receivables), and government securities (the Real Estate Assets).⁴⁶

For purposes of these Asset Tests, §856(c)(4) also provides that a REIT that meets these Asset Tests at the close of any quarter shall not lose its status as a REIT because of a discrepancy attributable to changes in the value of its various investments unless such discrepancy exists immediately after the acquisition of

⁴² See generally §856.

⁴³ The RIA was included in the American Jobs Creation Act of 2004, P.L. 108-357.

⁴⁴ §856(c)(3).

⁴⁵ §856(c)(2).

⁴⁶ §856(c)(4)(A).

any security or other property and is wholly or partly the result of such acquisition (the Revaluation Rule).⁴⁷ The Asset Tests do not expressly address how assets are to be valued when assets are denominated in a foreign currency. Nor do they address specifically whether foreign currency is cash or a cash item.

iii. Foreclosure Property

In general, under §856(c)(2)(F) and (c)(3)(F), for a limited period, income and gain from real property that a REIT has acquired through foreclosure may qualify as 95% Income and 75% Income so long as the property meets the definition of foreclosure property under §856(e). Section 857(b)(4)(A) imposes a corporate-level tax at the highest corporate tax rate on a REIT's net income from foreclosure property over deductions attributable to that property to the extent that income does not constitute qualifying 75% Income (other than through application of §856(c)(3)(F)).

iv. Tax on Prohibited Transactions

Section 857(b)(6) imposes a 100% “prohibited transactions” tax on REITs with respect to gains from sales of property held as inventory (dealer sales).

b. Issues Applicable to Overseas Investment under Pre-RIDEA Law

The IRS has acknowledged since 1974⁴⁸ that although a REIT must be taxable as a domestic corporation, it is permitted to invest in foreign real estate provided that it satisfies the general REIT requirements of the Code. With that said, prior to the enactment of RIDEA, Congress had only implicitly approved of investment by REITs in foreign real estate.

Over the past decade, more and more REITs have been investing in overseas real estate, typically by making investments directly or through subsidiary entities in the applicable foreign currency of the respective foreign jurisdiction. Foreign investment implicates §§985 through 989 of the Code, which govern the federal tax treatment applicable to a taxpayer's business or investment activity using a currency other than the taxpayer's functional currency (a “nonfunctional currency”). In general, §985 provides that all determinations for Federal income tax purposes are made in the taxpayer's “functional currency.”

Section 985(b)(1)(B) defines functional currency as the dollar except in the case of a qualified business unit (QBU), in which case the functional currency is “the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its

books and records.” Section 989(a) defines a QBU as any separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records — essentially a branch or division of the taxpayer. Regs. §1.985-1(b)(1)(iii) states that, except as otherwise provided by ruling or administrative pronouncement, the dollar shall be the functional currency of a QBU that has the United States as its residence as defined in §988(a)(3)(B).

Foreign investment in a currency other than the U.S. dollar (or, more broadly, currency other than the functional currency of the investor) may result in the recognition of foreign exchange gain or loss under §987 or §988, depending on the type of activity and/or the entity conducting the activity, as further described below. Because foreign currency gain was not explicitly included in the definition of 95% Income and 75% Income, REITs investing overseas faced uncertainty at best and disqualification at worst to the extent they might realize foreign currency gains from their activities. To avoid recognition of §§987 and 988 gains from foreign investment, many REITs sought and obtained private rulings from the IRS allowing them to form “subsidiary REITs” whose functional currency would be that of the local foreign jurisdiction, rather than the U.S. dollar.⁴⁹ However, the subsidiary REIT structure was administratively cumbersome, difficult to explain to investors, and never fully addressed the underlying problem of a REIT or its subsidiary's recognizing foreign currency gain. Furthermore, these private letter rulings may be relied upon only by the taxpayer to whom they were issued.

i. Section 988 Transactions

Section 988 requires that foreign exchange gains be recognized in connection with certain specified transactions. The transactions covered by §988 include: 1) the acquisition of or becoming the obligor under a debt instrument denominated in foreign currency (a §988 Lending Transaction) (e.g., a loan by or to a U.S.-based REIT denominated in Euros); 2) the accrual of an item of expense or gross income denominated in foreign currency that is to be paid or received after the date on which the item is accrued (a Non-Functional Currency Accrued Transaction) (e.g., the accrual of a payment in Euros by a U.S.-based REIT to a service provider); 3) entering into or acquiring a forward contract, futures contract, option, or similar financial instrument; and, 4) the disposition of non-functional currency (e.g., the exchange of Euros for U.S. Dollars by a U.S.-based REIT).

ii. Section 987: QBU Remittances

A U.S. taxpayer recognizes an exchange gain or loss under §987 (“§987 Gain or Loss”) when it in-

⁴⁷ §856(c)(4) (flush language).

⁴⁸ Rev. Rul. 74-191, 1974-1 C.B. 170.

⁴⁹ See PLRs 200821020, 200550025, 200550017, 200550010, 200519007, 200532015, 200531013, and 200548004.

vests in foreign property through a QBU that is considered a branch for federal tax purposes. For this purpose, an entity treated as a disregarded entity or partnership for federal tax purposes could be considered a branch. A §987 Gain (or Loss) occurs when the QBU remits funds to the U.S. taxpayer. Generally, the measure of the §987 Gain (or Loss) is the difference between the current dollar value of the remitted funds and the dollar value of the remitted funds at the time such funds were contributed to, or earned by, the QBU. In other words, the U.S. taxpayer realizes a §987 Gain when exchange rate on the date of remittance differs from the exchange rate applicable when funds were contributed to the QBU or the U.S. taxpayer accounts for its share of the QBU's income.

iii. Miscellaneous Issues

Pre-Act, there was ambiguity as to whether foreign currency held in connection with a REIT's business of owning foreign property and mortgages on foreign property could qualify as "cash." Furthermore, just as the recognition of foreign currency gains in the course of a REIT's normal investing activities created uncertainty in the application of the REIT income tests, it also could raise issues in connection with the 100% tax on prohibited transactions (at least on a theoretical level, to the extent such gains may be realized in connection with the sale of dealer property).

iv. 2007 IRS Guidance

In 2003, NAREIT began a dialogue with the Internal Revenue Service and the Treasury Department about how foreign currency gains that a REIT generates from its overseas operations should be treated under the REIT income tests and how foreign currency should be treated under the REIT asset tests. The government placed this issue on its priority guidance list for almost four years until it issued Rev. Rul. 2007-33⁵⁰ and Notice 2007-42.⁵¹

The IRS ruled in Rev. Rul. 2007-33 that if §988 currency gain is recognized by a REIT with respect to an item of income, the §988 gain will constitute 95% Income and 75% Income, respectively, to the extent the underlying income so qualifies. Rev. Rul. 2007-33 did not address the treatment of §988 gain when the REIT is an obligor on a debt instrument (in which case, it is the REIT's principal repayment and interest expense, not any item of income, that is causing the foreign currency gain) or in connection with a REIT's receipt of principal payments on debt instruments that it holds (again, in which case, there may be no underlying income).

The former issue was resolved in the case of a particular taxpayer by the IRS in PLR 200808024. In

PLR 200808026, the IRS concluded that to the extent the REIT in the ruling recognizes §988 income on loans used to acquire assets from which qualifying REIT income is derived, there is sufficient nexus to treat that §988 income as qualifying REIT income. Although PLR 200808024 did not address the issue of currency gains on a REIT's receipt of principal payments from a borrower, presumably the IRS would apply a similar analysis to treat these gains as qualifying income to the extent that they are derived from assets that generate qualifying REIT income. PLR 200808024 may not be relied upon by other taxpayers. Thus, even after Rev. Rul. 2007-33, both remaining issues are not completely resolved.

In Notice 2007-42, the IRS held that that if a REIT recognizes §987 currency gains attributable to the repatriation of foreign denominated funds by a QBU, the REIT may apply the principles of <http://www.irs.gov/pub/irs-regs/20827086.pdf> proposed regulations issued September 7, 2006 (requiring that §987 gains be proportionately attributed to the character of the underlying assets giving rise to such gains) (the Proposed §987 Regulations)⁵² to determine whether the currency gain is derived from 75% Income or 95% Income and therefore whether the currency gain would qualify as such income. The Notice stated that it could be relied on until the IRS amends the Proposed §987 Regulations to apply to REITs. This guidance was labeled "interim" because it was based on applying the principles of proposed regulations that, by their terms, did not apply to REITs, but which the IRS planned to amend.

c. The Act

i. Generally

Like the 2007 guidance, the Act addressed the treatment of foreign currency gains for purposes of the REIT income tests, but it used a different approach by excluding qualifying gains from the tests altogether rather than treat them as qualifying income.⁵³ Specifically, §3031(a) of the Act added new §856(n)(1), which provides that "passive foreign exchange gain" shall not constitute gross income for purposes of

⁵² REG-208270-86 (9/7/06). By their terms, these proposed regulations did not apply to REITs.

⁵³ As noted in footnote 8 above, the original version of RIDEA would have treated these foreign currency gains as qualifying income, rather than as excluded income, but the final version of RIDEA was changed in response to inquiries by the Joint Tax Committee staff, who felt that the exclusionary approach was more appropriate from a tax policy perspective. The staff believed that excluding such gains from both the numerator and the denominator of the fraction used to compute the gross income tests adequately protected REITs from disqualification, without increasing the amount of income which could be accommodated in the non-qualifying "basket."

⁵⁰ 2007-21 I.R.B. 1281.

⁵¹ 2007-21 I.R.B. 1288.

§856(c)(2) (i.e., 95% Income), and that “real estate foreign exchange gain” shall not constitute gross income for purposes of §856(c)(3) (i.e., 75% Income). As discussed in IV, D, 2, below, the Act also modified the REIT hedging rules contained in §856(c)(5)(G) to encompass more comprehensively foreign currency gains derived from risk management transactions.

Real estate foreign exchange gain is defined as foreign currency gain (as defined in §988(b)(1)) that is attributable to: 1) any item of 75% Income; 2) the acquisition or ownership of obligations secured by mortgages on real property or interests in real property; or, 3) becoming or being the obligor under obligations secured by mortgages on real property or on interests in real property.⁵⁴ Real estate foreign exchange gain also includes §987 gain attributable to a QBU of the REIT if the QBU itself meets the 75% income test for the taxable year, and meets the 75% asset test at the close of each quarter of the REIT that has directly or indirectly held the QBU.⁵⁵ The QBU is not required to meet the 95% income test in order for this §987 gain exclusion to apply. Real estate foreign exchange gain also includes any other foreign currency gain as determined by the Secretary of the Treasury.⁵⁶

Passive foreign exchange gain includes all real estate foreign exchange gain, and in addition includes foreign currency gain which is attributable to: 1) any item of 95% Income; 2) the acquisition or ownership of obligations; 3) becoming or being the obligor under obligations; and, 4) any other foreign currency gain as determined by the Secretary of the Treasury.⁵⁷

Notwithstanding the foregoing rules, except in the case of certain income that is excluded under the amended hedging rules of §856(c)(5)(G), any §988 gain derived from engaging in dealing, or substantial and regular trading, in securities (as defined in §475(c)(2)) will constitute non-qualifying gross income.⁵⁸

Importantly, the Joint Tax Committee emphasized that in the case of §988 transactions, the Act treats only §988 gains directly attributable to qualifying REIT income as either real estate foreign exchange gain or passive foreign exchange gain. Section 988 gains that are only indirectly related to qualifying REIT income do not constitute qualifying income. For example,

foreign currency gain attributable to exchange rate fluctuations between the time of the accrual of interest income on a foreign-currency

denominated obligation secured by a mortgage on real property and the time of payment, would constitute excluded income for purposes of both the 75-percent and 95-percent income tests. However, any additional foreign currency gain arising from subsequent disposition of the foreign currency received upon payment of the accrued interest would be attributable to holding the foreign currency after its receipt and would not constitute excluded income under either test; rather it would be non-qualifying income.⁵⁹

Similarly, while the Act treats §987 gains from a QBU that meets the applicable REIT income and asset tests as real estate foreign exchange gain, any foreign currency gain that arises after the remittances from the QBU would not constitute qualifying REIT income.⁶⁰

ii. Effect on 2007 IRS Guidance

The Joint Committee on Taxation noted that the Act’s approach of excluding “qualified” foreign currency gains from the REIT gross income tests differs from the Rev. Rul. 2007-33 approach of treating such “qualified” foreign currency gains as qualified REIT gross income. The Joint Committee on Taxation also noted that the Act went beyond the holding in Rev. Rul. 2007-33:

The effect of these rules is to change the result of Rev. Rul. 2007-33 in the case of foreign currency gain attributable to an item of REIT income that qualifies under §856(c)(2) and §856(c)(3), respectively, because the provision excludes such gain (solely for purposes of the relevant income test) rather than treating such gain as qualified income for purposes of that test. The provision in addition excludes foreign currency gain attributable to principal payments received on certain REIT assets, or to principal or interest payments with respect to certain liabilities of a REIT, situations not addressed in the revenue ruling.⁶¹

Similarly, the Joint Tax Committee noted that “[t]he rules of the provision also supersede Notice

⁵⁴ §856(n).

⁵⁵ §856(n)(2)(B).

⁵⁶ §856(n)(2)(C).

⁵⁷ §856(n)(3).

⁵⁸ §856(n)(4).

⁵⁹ Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, the “Housing Assistance Tax Act of 2008,”* (JCX-63-08), July 23, 2008, at 45.

⁶⁰ *Id.*

⁶¹ Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, the “Housing Assistance Tax Act of 2008,”* (JCX-63-08), July 23, 2008, at 44.

2007-42 in the case of remittances from a QBU that uses a functional currency other than the dollar.”⁶² So long as the QBU meets the quarterly assets tests and the 75% Income test for a taxable year, the new provisions exclude from the REIT income tests §987 gain on a remittance from the QBU to the REIT, and no tracing-type rules with respect to such §987 gain are imposed, as would have been the case under Notice 2007-42. The Joint Tax Committee then noted that “[i]t is expected that the Treasury Department will use its regulatory authority⁶³ to provide appropriate rules with respect to the treatment of §987 currency gain for purposes of the REIT gross income tests if a QBU does not meet the requirements of the provision.”⁶⁴

iii. Conforming Changes to Asset Test

Furthermore, the Act made certain changes to the REIT asset tests with respect to foreign currency. Specifically, Section 3032(a) of the Act modified §856(c)(4)(B) (flush language), which provides that a REIT will not fail the asset tests solely because of a discrepancy due to variations in value that are not attributable to the acquisition of investments. The Act clarified this rule to include discrepancies caused by changes in foreign currency exchange rates used to value foreign assets.

Section 3032(b) of the Act also clarified the definition of the term “cash” in §856(c)(5)(K) (added by Act §3031(c)) to include foreign currency if the REIT or its QBU uses such foreign currency as its functional currency and “to the extent that such foreign currency is held for use in the normal course of the activities of the [REIT or QBU] which give rise to [95% Income or 75% Income] or are directly related to acquiring or holding [qualifying REIT] assets” and is not held in connection with a trade or business of trading or dealing in securities (as defined in §475(c)(2)).⁶⁵

iv. Other Conforming Changes: Foreclosure Property Income and Prohibited Transactions Net Income

Additionally, the Act provided that net income from foreclosure property under §857(b)(4)(B) also includes foreign currency gain that is attributable to otherwise permitted foreclosure property income.⁶⁶ Finally, the Act amended §857(b)(6)(B)(i) so that foreign currency gain under §988(b)(1) or loss under

§988(b)(2) that is attributable to a prohibited transaction⁶⁷ is taken into account in determining the amount of prohibited transaction net income subject to the 100% prohibited transactions tax.

v. Effective Dates

The changes made by §3031(a) of the Act (excluding passive foreign exchange gain and real estate foreign exchange gain from 75% Income and 95% Income) apply to gains and items of income recognized after July 30, 2008.⁶⁸ The changes made by §3031(c) of the Act (allowing the IRS to exclude income from the 95% and 75% Income tests) similarly are effective for gains and items of income recognized after July 30, 2008.⁶⁹

The changes to the asset test made by §3032 of the Act apply to taxable years beginning after July 30, 2008.⁷⁰

The changes made by §3033(a) (relating to foreign currency gains attributable to foreclosure property income) apply to gains recognized after July 30, 2008.⁷¹ Finally, the changes made by §3033(b) (relating to foreign currency gains attributable to a prohibited transaction) apply to gains and deductions recognized after July 30, 2008.⁷²

2. Hedging

a. Background

Under pre-RIDEA law, §856(c)(5)(G) generally provided that income from a hedging transaction that is clearly identified is not considered 95% Income to the extent that the transaction hedges any indebtedness incurred or to be incurred to acquire or carry real estate assets. For this purpose, a hedging transaction is one defined in §1221(b)(2)(A)(ii) or (iii) that is clearly identified under §1221(a)(7). Regs. §1.1221-2 contains a procedure for “clearly identifying” hedging transactions under §1221(b)(2)(A) (generally, the same day as entered into), as well as curative provisions when there is a failure to identify such transactions due to inadvertent error.

b. The Act

i. Exclusion from Both 75% Income and 95% Income

Section 3031(b) of the Act expanded §856(c)(5)(G) so that income from a hedging transaction as defined in §1221(b)(2)(A)(ii) or (iii), which is clearly identified pursuant to §1221(a)(7), is excluded not only

⁶² *Id.*

⁶³ Section 989(c) grants the IRS authority to issue regulations under the foreign currency provisions of §§985-989.

⁶⁴ Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, the “Housing Assistance Tax Act of 2008,”* (JCX-63-08), July 23, 2008, at 45.

⁶⁵ §856(c)(5)(K)(i) and (ii).

⁶⁶ 2008 Housing and Economic Recovery Act §3033(a).

⁶⁷ 2008 Housing and Economic Recovery Act §3033(b).

⁶⁸ 2008 Housing and Economic Recovery Act §3071(b)(1).

⁶⁹ *Id.*

⁷⁰ 2008 Housing and Economic Recovery Act §3071(a).

⁷¹ 2008 Housing and Economic Recovery Act §3071(c)(1).

⁷² 2008 Housing and Economic Recovery Act §3071(c)(2).

from being 95% Income, but also from being 75% Income.

ii. Expanded Definition of Hedging

Section 3031(b) of the Act also added §856(c)(5)(G)(ii) (and redesignated pre-RIDEA §856(c)(5)(G), as modified above, as §856(c)(5)(G)(i)). This new §856(c)(5)(G)(ii) generally excludes from gross income, for purposes of both REIT gross income tests, the income from an additional type of hedging transaction. Specifically, income from hedging transactions entered into primarily to manage the risk of currency fluctuations with respect to any item of income or gain that would be 75% Income or 95% Income (or any property which generates such income or gain) is excluded from gross income for purposes of the REIT gross income tests. This income is only excluded if the transaction is clearly identified as such before the close of the day on which the transaction was acquired, originated, or entered into (or such other time as the Secretary may prescribe).⁷³

The modified REIT hedging rule in §856(c)(5)(G)(ii) applies to foreign currency risk management transactions that are not covered by §1221(b)(2)(A)'s definition of a "hedging transaction." While §1221(b)(2)(A) is limited to transactions that manage risks with respect to ordinary property held or to be held by the taxpayer, borrowings made or to be made by the taxpayer, or ordinary obligations incurred or to be incurred by the taxpayer, §856(c)(5)(G)(ii) covers foreign currency risk management transactions with respect to items of income or gain and capital assets that generate such items of income or gain. For example, §856(c)(5)(G)(ii) could apply to foreign currency derivative contracts that are used to hedge foreign currency risk associated with foreign currency-denominated debt instruments held by a REIT.

Although the Act added §856(n)(4), which generally provides that any §988 gain derived from engaging in dealing, or substantial and regular trading, in securities (as defined in §475(c)(2)) will constitute non-qualifying REIT income for purposes of the REIT gross income tests,⁷⁴ this limitation does not ap-

ply to income that does not constitute gross income by reason of §856(c)(5)(G) (as amended by the Act).⁷⁵

iii. Effective Date

Section 3031(b) of the Act's modification to the REIT hedging rules applies to transactions entered into after July 30, 2008.⁷⁶

iv. Guidance Requested on "Clearly Identifying" under New §856(c)(5)(G)(ii)

As noted above, Regs. §1.1221-2 contains a procedure for "clearly identifying" hedging transactions under §1221(b)(2)(A), as well as curative provisions when there is a failure to identify such transactions due to inadvertent error. However, these regulations do not appear to apply to transactions encompassed by §856(c)(5)(G)(ii), which also are required to be "clearly identified as such before the close of the day on which . . . acquired, originated, or entered into (or such other time as the Secretary may prescribe)."⁷⁷

For this reason, on August 13, 2008, NAREIT submitted a letter to the IRS and Treasury Department, requesting guidance under H.R. 3221 in order to comply with the requirement in §856(c)(5)(G)(ii) that a transaction described therein be clearly identified in a timely manner and to determine the consequences of an inadvertent failure to properly identify a transaction. Because the statutory language in §856(c)(5)(G)(ii) closely resembles that in §1221(a)(7), it seems that the principles of the §1221 hedging regulations generally may be appropriate for application to foreign currency risk management transactions that are covered by §856(c)(5)(G)(ii) but that are not "hedging transactions" under §1221(b)(2)(A).

As noted above, in connection with the modified hedging rule contained in §856(c)(5)(G)(i) (limited to hedging transactions as defined in §1221(b)(2)(A)(ii) or (iii), and specifically requiring that such transactions be clearly identified pursuant to §1221(a)(7)), the hedging regulations under §1221 contain a curative provision in cases when there is a failure to identify a hedging transaction due to inadvertent error.⁷⁸ However, this provision technically does not treat an inadvertent failure to identify as a clear identification under §1221(a)(7). Instead, it provides for the same tax consequences as a clearly identified hedging transaction (i.e., treatment of gain or loss from a transaction as ordinary income or loss).

Some practitioners have raised the issue as to whether the clear identification requirement in

⁷³ In the case of foreign currency risk management transactions, the exclusion of such income from 95% and 75% Income generally seems to correspond to the treatment of real estate foreign exchange gains and passive foreign exchange gains for purposes of these tests, so the significance of applying the modified REIT hedging rule to income from foreign currency risk management transactions may be limited.

⁷⁴ 2008 Housing and Economic Recovery Act §3031(a)(4), adding §856(n)(4) to the Code.

⁷⁵ *Id.*

⁷⁶ 2008 Housing and Economic Recovery Act §3071(b)(2).

⁷⁷ §856(c)(5)(G)(ii).

⁷⁸ Regs. §1.1221-2(g)(2)(ii).

§856(c)(5)(G)(i) could be interpreted as not encompassing the curative provisions under the §1221 regulations. Consequently, NAREIT requested that guidance be issued to clarify that §856(c)(5)(G)(i) (and presumably §856(c)(5)(G)(ii)) applies to hedging transactions to which the curative provisions of the §1221 hedging regulations apply.

E. Other Qualified Activities

1. Background

Questions have arisen because certain types of income are not described specifically as 95% Income or 75% Income, 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 as discussed above, subpart F income under §952, 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.⁷⁹ In addition, the IRS has issued several private letter rulings that partly address the foreign currency issue through the complicated and burdensome use of “subsidiary REITs.”⁸⁰ Unfortunately, these rulings cannot be relied on by other taxpayers and in any event do not cover all circumstances.

2. The Act

The Act added §856(c)(5)(J), expressly providing the Department of the Treasury the authority to issue guidance on whether other items of income either qualify as 75% Income or 95% Income or to provide that other items of income are not taken into account in computing the 75% and 95% income tests. Legislative history⁸¹ suggests that the IRS should 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, should either be consid-

⁷⁹ See, e.g., PLRs 200726002 (goodwill gain), 200614024, 200528004 (refunded state tax credits), 200414025 (guarantor substitution payment), 200127024 (merger and acquisition break-up fee), 200115023 (gross income from §481 adjustment), 200039027, and 9636014 (litigation settlement fees).

⁸⁰ See footnote 49 above and the accompanying text.

⁸¹ 153 Cong. Rec. E384 (Daily Digest, Remarks of Representative Joseph Crowley, Feb. 16, 2007).

ered qualifying REIT income or income that is not taken into account for purposes of the gross income tests.

On August 13, 2008, NAREIT submitted a letter to the IRS and Treasury Department requesting guidance that addresses these issues raised in the legislative history. The 2008-09 IRS Priority Guidance Plan, released on September 10, 2008, includes an item relating to the Housing Tax Assistance Act of 2008, the tax title of H.R. 3221. NAREIT is hopeful that the IRS will address these issues in the foreseeable future.

V. REMAINING RIDEA ISSUE: FOREIGN REIT

A. Background

The number of countries that have adopted REIT-like legislation this past decade has greatly grown. Especially notable, U.K., German and Italian REIT laws went into effect in 2007, with Finland, South Africa, Spain and other countries expected to follow suit within the next year. Even developing countries like India have floated the concept of REIT-like legislation. Although the 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.⁸² 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.

B. RIDEA

RIDEA would have treated 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

⁸² See §856(c)(4)(B)(iii)(II) and (III). However, the U.S. REIT can elect TRS status with the foreign REIT, and thereby preserve U.S. REIT qualification for itself. §§856(c)(4) and 856(l).

required to distribute at least 85%⁸³ of its taxable income to shareholders on an annual basis. The Treasury Department would have been tasked with the responsibility of issuing guidance as to which countries' laws satisfied these requirements.

⁸³ The 85% threshold was selected to accommodate the rules for French REITs.

C. Outlook

The RIDEA foreign REIT provisions were not included in the Act, primarily for budget reasons. NAREIT is expected to continue to work with policymakers to include such provisions in future tax legislation.