NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

Statement of the

National Association of Real Estate Investment Trusts®

to the

Subcommittee on Select Revenue Measures

of the

Committee on Ways and Means

Regarding the Hearing Held June 15, 2010 on

H.R. 4337, the Regulated Investment Company Modernization Act of 2009

June 25, 2010

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The National Association of Real Estate Investment Trusts® (NAREIT) respectfully submits these comments in connection with the hearing of the Select Revenue Measures Subcommittee of the Committee on Ways and Means held on June 15, 2010, regarding H.R. 4337, the Regulated Investment Company Modernization Act of 2009 (RICMA). NAREIT thanks the Chairman, the Ranking Member and the Subcommittee for the opportunity to provide these comments. Over the last fifty years since Congress authorized the real estate investment trust (REIT) election based on the regulated investment company (RIC) model, Congress has conformed the law for both types of entities in a consistent manner. NAREIT suggests the following improvements to RICMA set forth below.

NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

EXECUTIVE SUMMARY

NAREIT recommends that Congress enact the following legislative changes, which are discussed in more detail below:

1) modify and improve the "RIC Savings" rules in H.R. 4337 (based on the existing "REIT Savings" rules) to allow RICs and REITs to choose to apply an increased monetary penalty for a RIC or REIT test failure when the current "reasonable cause" standard is not met so long as the principal purpose of the failure is not to circumvent one or more of the RIC or REIT test requirements (this change is supported by the Investment Company Institute);
2) conform the proposed elimination of the preferential dividend rule for "publicly offered" RICs to "publicly offered" REITs;
3) update and modify the REIT dealer sales safe harbor and corresponding provisions so that a taxable REIT subsidiary (TRS) is allowed to provide the same services as an independent contractor without adverse tax consequences to the affiliated REIT; and,
4) clarify and modernize the REIT income and asset tests, and, in some cases, make permanent temporary provisions relating to the ownership of timber, as set forth below.

DISCUSSION

I. MODIFY AND IMPROVE THE "RIC SAVINGS" RULES OF H.R. 4337

A. Background: REIT Savings Existing Provisions and RIC Savings Proposal

By way of background, the Internal Revenue Code[1] contains REIT Savings[2] provisions, most of which were enacted in 2004, that generally allow a REIT to remedy one or more failures to satisfy the REIT asset tests under section 856(c)(4), income tests under sections 856(c)(2) and (3), or "other" REIT requirements under section 856(g) by remedying the failure and paying a monetary penalty. One requirement in order to remedy most of the REIT test failures is that the failure be due to "reasonable cause and not due to willful neglect."

H.R. 4337 generally would allow RICs to apply existing REIT Savings rules in the RIC context.

B. Issue: "Reasonable Cause" Generally Required, But Difficult to Ascertain With Complete Certainty

Although the enactment of the REIT Savings provisions was very welcome, the operation of these provisions could be significantly improved. It is frequently difficult for both taxpayers and the IRS to conclude with certainty that any REIT test failure is due to reasonable cause and not willful neglect, largely because there is little precedent dealing with taxpayers that are attempting to comply with complex technical rules. In addition, because many technical failures are due to inadvertence, loss of REIT status in those circumstances would be grossly disproportionate to the technical nature of the violation. Further, the time spent both by the government and taxpayers on closing agreements to resolve these issues is significant and inefficient.

While NAREIT supports the extension of the REIT Savings provisions to RICs, NAREIT suggests the proposal below as an improvement to avoid the above-noted problem both for RICs and REITs.

C. Proposal: Increased Monetary Penalty if Unclear "Reasonable Cause" Met So Long as Principal Purpose to Circumvent Rule is Absent

Our proposal would allow RICs and REITs to choose to apply an increased monetary penalty for inadvertent RIC or REIT test failures when the current "reasonable cause" standard is not met so long as the principal purpose of a failure is not to circumvent one or more of the RIC or REIT test requirements. *The existing penalties still would apply if it is clear to the REIT or RIC that reasonable cause exists*. This proposal is supported by the Investment Company Institute.

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[1] The Internal Revenue Code of 1986, as amended (the Code), and, unless otherwise provided, "section" refers to a section of the Code.

[2] The REIT Savings provisions are codified as Internal Revenue Code sections 856(c)(7) and 856(g)(5). They originated as Title III of H.R. 1890 and S. 1568, the REIT Improvement Act of 2003, which was enacted as part of the American Jobs Creation Act of 2004, Pub. L. No. 108-357. A related provision, section 856(c)(6), which imposes a tax in connection with the failure to satisfy the REIT gross income tests under sections 856(c)(2) and (c)(3), originated as part of the Tax Reform Act of 1976, Pub. L. No. 94-455.

Specifically, we recommend the following:

1) Asset Tests Failures: Increase the current penalty from the greater of $50,000 or 100% of the income generated by the offending asset beginning on the date of the asset test failure multiplied by the highest corporate tax rate to the greater of $100,000 or 110% of the income generated by the offending asset beginning on the date of the asset test failure multiplied by the highest corporate tax rate, plus interest accruing on the latter amount from the original due date of the tax return for the year in which the violation first occurred until the date of payment. Additionally, the definition of *de minimis* asset test failures would be modified to include only asset test failures under section 856(c)(4)(B)(iii) that are due to the ownership of assets the total value of which does not exceed the *greater* of (rather than the lesser of): i) 1% of the total value of the REIT's assets at the end of the relevant quarter; or, ii) $10 million.

2) Income Tests Failures: Increase the current penalty of 100% to 110% of the amount by which the REIT failed either the 75% or 95% income test, as reduced by deductions allocable to such income, plus interest from the due date of the tax until the date of payment.

3) Other REIT Test Violations Under Section 856(g): Increase the current penalty from $50,000 to $100,000 for the first identification of such failure and to a specific level, *e.g.,* $350,000 for any subsequent failures, plus interest from the original due date of the tax return applicable to the year in which the failure occurred until the date of payment. Additionally, in response to an IRS request, the REIT would be required to provide separate notice to the IRS of its identification of a section 856(g) failure, and the IRS would have a specific opportunity to review. This proposal would not apply to RICs as they are not subject to a provision similar to section 856(g).

II. CONFORM THE PROPOSED ELIMINATION OF THE PREFERENTIAL DIVIDEND RULE FOR "PUBLICLY OFFERED" RICS TO "PUBLICLY OFFERED" REITS

A. Background: Preferential Dividends

Both RICs and REITs are allowed a deduction for dividends paid to shareholders (the DPD). In order for a dividend to qualify for the DPD, it must not be a "preferential dividend." A dividend is considered to be preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class compared with another except to the extent the class is entitled to such preference. A preferential dividend is not deductible and can cause a REIT or RIC to fail to satisfy its annual distribution requirement. H.R. 4337 would eliminate the preferential dividend rule for "publicly offered" RICs (generally regularly traded, continuously offered, or held by at least 500 shareholders).

B. Issue

As is the case for RICs, the preferential dividend rule for REITs is redundant in light of current securities laws and not necessary to prevent tax avoidance. In addition, the preferential dividend rule does not allow for *de minimis* or inadvertent errors, or for corrections of those errors, that technically may constitute preferential dividends, with the draconian consequence of loss of REIT/RIC status far exceeding the severity of the error. The foregoing is particularly true in the case of REITs and RICs that are required to file annual and periodic reports with the SEC under the Securities Exchange Act of 1934 (1934 Act) due to the transparency these reports provide to the public and the government. These REITs are companies with more than $10 million in assets whose securities are held by more than 500 owners.

The body of federal and state corporate and securities law has evolved significantly since the 1936 enactment of the preferential dividend rule. The preferential dividend rule was adopted: i) prior to the enactment of the Investment Company Act of 1940 that contains its own protections against the use of preferential dividends to create overly complicated capital structures and ensures equal and fair treatment for investors in mutual funds;[3] and, ii) without taking into account the developing body of corporate and securities law cases that protect corporate shareholders against unequal treatment,[4] and certain rules of the Securities Exchange Act of 1934 that provide disclosure to shareholders of "public" entities.[5] The preferential dividend rule contained in the tax code has largely served as an unintended trap for REITs and RICs that make inadvertent processing or computational errors.

NAREIT believes that the preferential dividend rule is not needed to prevent tax avoidance.[6] Moreover, the burden it creates on REITs and RICs and the IRS far outweighs any benefit that it may achieve. The bill would repeal the preferential dividend rule contained in the tax code for publicly offered RICs and also should repeal the preferential dividend rule for publicly offered REITs.

Congress enacted the preferential dividend rule to prevent tax avoidance by shareholders of personal holding companies (PHCs) and to promote shareholder fairness.[7] PHCs by definition

[3] Investment Company Act, 15 U.S.C. § 80a-18 (1940).
[4] *McPhail v. L.S. Starrett Co*., 157 F. Supp. 560 (D. Mass. 1957); *Penfield v. Davis*, 105 F. Supp. 292 (N.D. Ala. 1952); *Bodell v. General Gas & Electric Corp.*, 132 A. 442 (Del. Ch. 1926); *Hannigan v. Italo Petroleum Corp. of America*, 77 A.2d 209 (Del. 1949).
[5] Securities Exchange Act, 15 U.S.C. § 78i (1934).
[6] For further discussion of this issue, *see* New York State Bar Association, Tax Section, Report on the Application of Code Section 562(c) to Regulated Investment Companies and Real Estate Investment Trusts (April 7, 2008) [http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1153Letter.pdf].
[7] *See* sections 561, 562 and 565. Congress enacted the Preferential Dividend Rule in the Revenue Act of 1936; The legislative record indicates that tax avoidance was the primary concern of Congress:

> No dividends-paid credit should be allowed in the case of a distribution not in conformity with the rights of shareholders generally inherent in their stockholdings, whether the preferential distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance…The committee believes that no distribution which treats shareholders with substantial impartiality and in a manner consistent with their rights under their stockholding interests should be regarded as preferential by reason of minor differences in valuations of property distributed. H.R. Rep. No. 1860, 75th Cong., at 31 (1938).

are closely-held corporations.[8] PHCs can effect tax avoidance by obtaining waivers of dividend rights from some shareholders with higher marginal tax rates and paying larger dividends to other shareholders (often family members) with lower marginal tax rates. The preferential dividend rule prevents this income splitting means of tax avoidance.

The rationale of such a tax avoidance rule, which is designed to prevent abuses by shareholders of closely-held PHCs, does not apply to publicly offered REITs. Publicly offered REITs have widespread ownership and no incentive or ability to minimize tax; in fact, such REITs would typically have no way of knowing what the shareholders' tax rates are. Accordingly, the shareholders of publicly offered REITs cannot, as a practical matter, coordinate amongst themselves and with the REIT to effect income splitting through dividend waivers or unanimous agreements among shareholders, thereby favoring some shareholders over others.[9]

Moreover, shareholders of publicly offered REITs likely do not have knowledge of other shareholders to permit such coordination among shareholders with respect to dividend waivers. In the case of publicly offered REITs, the preferential dividend rule simply does not provide additional protection against tax avoidance through income splitting because as a practical matter the public shareholders do not and will not act in concert to favor one group of shareholders over another group. And, absent such waivers or unanimous agreements, applicable state law generally prohibits treating shareholders of an identical class of shares differently with respect to dividends on such shares.

In addition to creating the preferential dividend rule to prevent tax avoidance, Congress enacted the preferential dividend rule to provide "substantial impartiality" among shareholders. The drafting of the preferential dividend rule suggests that Congress wanted to ensure impartiality with respect to the tax burden placed on shareholders by requiring dividends to be paid pro rata, and thus spread the tax burden evenly among shareholders. The technical complexity involved in complying with the preferential dividend rule increases administrative, legal and accounting costs for REITs. REITs incur legal and accounting fees and expend resources to analyze and audit the application of the preferential dividend rule to their distributions, particularly when a REIT has several classes of stock. Additionally the IRS incurs costs and expends resources to audit and enter into closing agreements if the preferential dividend rule is violated, even if such violation is minor or inadvertent.

The binary nature of the preferential dividend rule results in insignificant errors often causing such a violation; for example, distributing money to shareholders in the correct amounts but in a chronological order other than the order set forth in underlying agreements, changing distributions due to changes in shareholder interests, decreasing distributions by different amounts for each shareholder due to differing advisory and administrative fees paid by each shareholder, and even having an incorrect shareholder address or making a rounding error. As

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[8] Section 542(a)(2) (requiring that 50% in value of a PHC's outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals).
[9] *See* n.4 above. Corporate law has permitted shareholders of closely held corporations to agree to such preferential dividends, *see Wabash Ry. Co. v. American Refrigerator Transit Co.*, 7 F.2d 335 (8th Cir. 1925); *Speier v. US*, 9 F. Supp. 1020 (Ct. Cl. 1935).

such the preferential dividend rule increases the costs to REITs and their shareholders rather than ensuring that the shareholders receive fair treatment with respect to dividends.

By increasing the likelihood of REITs technically violating the preferential dividend rule, the tax costs to shareholders also increases. When REITs do not receive the dividends paid deduction due a violation of the preferential dividend rule, REITs can fail to satisfy the distribution requirement and consequently the income retained by the REITs as well as the money distributed is taxable at corporate tax rates. The shareholders of REITs bear these tax costs and bear them equally even when the shareholders have not all benefited from the dividend preference. The burden placed on REITs and their shareholders due to the preferential dividend rule outweighs the benefits and often leads to more unequal treatment among shareholders.

The Treasury Department and IRS included an item on their Priority Guidance Plan in 2007 and 2008 that would have addressed corrections of minor errors by REITs and regulated investment companies (RICs). This guidance presumably would have addressed preferential dividends occurring as a result of a minor error.[10] Unfortunately, the 2009 Priority Guidance Plan omitted this issue, thus making the need for a legislative fix more urgent.

C. Proposal: Conform the Preferential Dividend Repeal for Publicly Offered RICs to "Public" REITs

NAREIT recommends conforming the repeal of the preferential dividends rule for publicly offered RICs to REITs that are required to file annual and periodic reports with the SEC under the 1934 Act.

III. MODIFY AND UPDATE REIT DEALER SALES SAFE HARBOR AND CORRESPONDING PROVISIONS

A. Background: 100% Tax on Dealer Sales

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

B. Dealer Sales Safe Harbor: Rental Properties

A safe harbor exception for rental property (Rental Property Safe Harbor) held for at least two years provides that a sale of a "real estate asset" will not be classified as a prohibited transaction if it meets all of the following requirements: 1) capital improvements that the REIT made to the property during the two years preceding the date of sale did not exceed 30% of the property's net selling price (30% Rule); 2) a) the REIT did not make more than seven sales of **"**property**"** during the year (Seven Sales Rule); or, b) (i) the aggregate adjusted bases of all "properties" sold during the year do not exceed 10% of the aggregate bases of all of the REIT's assets as of the

[10] *See* 2007-2008 Priority Guidance Plan [http://www.irs.gov/pub/irs-utl/2007-2008_pgp_initial.pdf] and 2008-2009 Priority Guidance Plan [http://www.irs.gov/pub/irs-utl/2008-2009_gpl.pdf].

beginning of the year, or (ii) the fair market value of all "properties" sold during the year does not exceed 10% of the fair market value of all of the REIT's assets as of the beginning of the year (10% Rule); and, 3) if the REIT is relying on the 10% Rule, substantially all of the marketing and development expenditures were made through an independent contractor, from whom the REIT receives no income (the Rental Marketing Rule).

C. Dealer Sales Safe Harbor: Timber Properties

A similar safe harbor (the Timber Property Safe Harbor) applies in the case of timber REITs. Although the Timber Property Safe Harbor is generally similar to the Rental Property Safe Harbor, the Timber Property Safe Harbor does reflect some refinements to the original safe harbor as well as some distinctions presumably based on the differences between timber property and rental property. Specifically, it limits to 5% the capital expenditures that can be incurred for non timber-related purposes (the 5% Timber Rule). Also, the relevant marketing rule (the Timber Marketing Rule) requires only marketing expenditures (not development expenditures) be made through an independent contractor, presumably because of the 5% Timber Rule. However, the Timber Property Safe Harbor generally limits other timber-related capital expenditures undertaken in the two years preceding sale to 30% of the property's net selling price. Unlike the Rental Marketing Rule, the Timber Marketing Rule temporarily permitted (through Dec. 31, 2009) a "taxable REIT subsidiary" (TRS), in addition to an independent contractor, to undertake substantially all of the marketing expenditures with respect to a particular property.[11]

D. Issues: Allowing Development for One's Own Account, Incorporating TRS Rules, and Only Considering Sales of "Real Property" With Respect to the Safe Harbor

First, although property development for one's own account is generally permitted without causing dealer status, the current Rental Property Safe Harbor's disqualification of a REIT's self-developed properties could result in loss of the safe harbor for these properties, even if developed by a REIT decades ago. The current rule is unnecessary because of the 30% Rule listed above, which denies the safe harbor if a REIT's expenditures includible in a property's tax basis made within two years of the property's sale is at least 30% of that property's net sales price. Second, both the Rental Property and the Timber Property Safe Harbors do not recognize fully the Congressional authorization of the use of TRSs beginning almost ten years ago. For example, the Rental Marketing Rule only authorizes an independent contractor, not a TRS, to provide development and marketing services without losing the safe harbor (unlike the temporary Timber Marketing Rule).

E. Proposals

First, the current Rental Property Safe Harbor should be updated so that it does not cause development for one's own account to result in loss of the safe harbor; and the Rental Marketing Rule should be limited to marketing, not development, expenditures as with the Timber Property Safe Harbor. Second, the dealer sales and corresponding provisions should be updated so that a TRS is allowed to provide the same services as an independent contractor.

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[11] H.R. 4213, as passed by the Senate on March 10, 2010, and the House on May 28, 2010, would extend this provision for an additional year.

IV. CLARIFY AND MODERNIZE THE REIT INCOME AND ASSET TESTS AND EXTEND CERTAIN RULES PERMANENTLY

A. Background: REIT Income and Asset Tests

Generally, in order to ensure that a REIT is real estate-focused, at least 75% of a REIT's annual gross income must be from certain delineated real estate-related sources like rents or interest on mortgages secured by interests in real property (75% Income), and at least 95% of a REIT's annual gross income (95% Income) must be from these sources, as well as other passive, non-real estate sources, like interest on bank deposits. Additionally, at least 75% of a REIT's gross assets quarterly must be from real estate assets, cash, and cash items.

B. Issues and Proposals

1) Clarify That Debt Securities of a REIT are Real Estate Assets. Although equity securities in a REIT are considered "real estate assets," unsecured debt securities of a REIT are not – notwithstanding their holders have a higher priority on the REIT assets than equity security holders. Legislation should treat debt securities of a REIT as a "real estate asset."

2) Conform REIT Income and Asset Tests by Treating Personal Property as a Real Estate Asset If it Amounts to Less than 15% of the Associated Real Property (by fair market value or adjusted tax basis). The income test treats rental income attributable to personal property as qualifying rental income so long as the rent attributable to such personal property for the taxable year does not exceed 15% of the total property rent for the taxable year. Similarly, the asset test should treat personal property rented along with associated real property as a qualifying real estate asset so long as such personal property (by fair market value or adjusted tax basis) does not exceed 15% of the total value of such real property.

4) Make Permanent and Extend to All REITs the Treatment of Mineral Royalties as Qualifying 95% Income for All REITs. Section 856(c)(2)(I) temporarily (through Dec. 31, 2009)[12] treated as qualifying income under the 95% gross income test "mineral royalty income" earned by a timber REIT from real property held, or once held, in connection with the trade or business of producing timber. Because mineral royalty income represents passive income from property, there is no policy reason as to why it should not be permanently extended and included as qualifying 95% Income for all REITs. In addition, legislation should clarify that the term "mineral royalty income" includes oil and gas royalties. [13]

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[12] H.R. 4213, as passed by the Senate on March 10, 2010, and the House on May 28, 2010, would extend this provision for an additional year.

[13] *See* Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in the "American Jobs and Closing Tax Loopholes Act of 2010," for consideration on the floor of the House of Representatives,* (JCX-29-10), footnote 250, May 28, 2010.

5) Treat Gain from Sale of Timber as Qualifying REIT Income for the 75% and 95% Income Tests. Sections 631(a) and 631(b) both treat gain from certain types of timber dispositions as gain from a sale or exchange. The IRS has issued a number of private rulings that section 631(b) gain is qualifying 75% and 95% Income. Section 856(c)(5)(H) temporarily treated certain gain from the disposition of timber under both sections 631(a) or (b) as qualifying 75% and 95% Income (generally through the end of 2009).[14] This provision codified the holdings of the rulings mentioned above and created a framework for treating section 631(a) income as qualifying REIT income. NAREIT recommends that this provision be extended permanently.

6) Treat "Carbon Credits" As Qualifying Assets That Generate Qualifying Income. Some countries allow for the ability to trade carbon credits (credits that allow a purchaser to pay another party, *e.g.,* a timber owner) to remove a certain quantity of carbon dioxide from the atmosphere), and Congress or states may do so in the future. It is important to consider the tax consequences to REITs, particularly timber REITs, so that these entities are encouraged to undertake more tree planting consistent with the goals of the legislation. Specifically, NAREIT recommends: 1) carbon credits should be viewed as qualifying real estate assets inextricably linked with the underlying real estate; 2) income from the sale of carbon credits should be considered qualifying 75% and 95% REIT Income; and, 3) gain from the sale of carbon credits should not be subject to the dealer sales rules.

7) Modify Hedging Rule to Cover Hedges Entered Into to Counteract Another Qualifying Hedge and Eliminate Same-Day Identification Requirement. Income attributable to certain "qualifying hedges" is considered 75% and 95% Income provided the hedges are identified on the same day entered into. NAREIT recommends that qualifying hedges include hedges entered into to counteract a qualifying hedge. Also, to prevent treatment of otherwise qualifying income as non-qualifying due in inadvertent failure to identify, we recommend elimination of the same-day identification requirement (or that some type of relief be permitted for inadvertent failure to same-day identify).

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NAREIT again thanks the Chairman, the Ranking Member and the Subcommittee for the opportunity to submit these comments on these important issues.

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[14] H.R. 4213, as passed by the Senate on March 10, 2010, and the House on May 28, 2010, would extend this provision for an additional year.