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National Policy Bulletin

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

National Policy Bulletin

SENATE REIT TAX BILL INTRODUCED

Executive Summary

On August 3, S. 2002, the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA) was introduced in the Senate by Senators Orrin Hatch (R-UT), Ken Salazar (D-CO), Gordon Smith (R-OR) and John Kerry (D-MA), all members of the Senate Finance Committee (the Senate committee with tax jurisdiction). CLICK HERE for Senator Hatch's introductory remarks from the Congressional Record that are followed by a section-by-section analysis of the proposed legislation.

S. 2002 serves as companion legislation to the House version of RIDEA, H.R. 1147, which was introduced by Representatives Joe Crowley (D-NY) and Eric Cantor (R-VA), among others, earlier in the year. It is important to note that over two-thirds of the House Ways and Means Committee (the House committee with tax jurisdiction) now sponsor H.R. 1147. CLICK HERE for the text of H.R. 1147 and the names of its co-sponsors.

S. 2002 parallels the provisions contained in H.R. 1147 except with respect to the proposed change in the 10 percent test in the dealer sales safe harbor. Current law measures the 10 percent standard by using tax basis whereas H.R. 1147 would use fair market value. S. 2002 would provide maximum flexibility by allowing a REIT to choose either method on an annual basis.

When Congress returns to Washington in September, NAREIT will be seeking additional support for S. 2002 among members of the Senate Finance Committee. At the same time, we will be working with our sponsors to secure the backing of Chairman Max Baucus (D-MT) and Ranking Republican Charles Grassley (R-IA) in the Senate, and Chairman Charles Rangel (D-NY) and Ranking Republican Jim McCrery (R-LA) in the House, for RIDEA's inclusion in forthcoming tax legislation.

RIDEA Provisions


Senators Orrin Hatch (R-UT) & Ken Salazar (D-Co)

1. Permissible REIT Investment Income

Background
In general, federal tax law requires that REITs meet specific tests regarding the composition of their gross income and assets. Specifically, 95 percent of their annual gross income must be from specified sources such as dividends, interests and rents, and 75 percent of their gross income must be from real estate related sources.

Issue
Certain types of income that are typically generated in the commercial real estate business are not mentioned specifically in the 95 percent or 75 percent baskets. Accordingly, if a 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 commercial real estate. Examples include: foreign currency gains attributable to a REIT's overseas real estate investments, amounts attributable to recoveries in settlement of litigation and "break up fees" attributable to a failure to consummate a merger with another REIT.[1]

Internal Revenue Service
United States Department of the Treasury

Proposal
Foreign currency gains a REIT derives with respect to its business of investing in "real estate assets" would be considered qualifying income under the REIT tests. S. 2002 would confirm the conclusion reached in May by the IRS in Revenue Ruling 2007-33 and Notice 2007-42 that most foreign currency gains a REIT recognizes from operating its real estate business qualify as "good income" under the REIT income tests, but S. 2002 would use a more direct and comprehensive approach and also conform other REIT rules such as the asset tests.

Further, under S. 2002 the IRS would have the authority to determine whether any item of income not specifically listed in the REIT gross income tests should either be qualified income or not taken into account in determining those tests. In the section-by-section analysis accompanying his introductory remarks, Senator Hatch stated:

> Under this authority, I would expect that, for example, the IRS would conclude that dividend-like items such as Subpart F deemed dividends and PFIC income would be treated in the same manner as dividends for purposes of the 95 percent gross income test. Further, the IRS could convert many of its rulings it issued to individual taxpayers into public guidance, which could be a more efficient use of its resources.

2. Raising Taxable REIT Subsidiary Limit

Background
As originally introduced in 1999, the REIT Modernization Act (RMA) limited a REIT's ownership in taxable REIT subsidiaries (TRSs) to 25 percent of the REIT's gross assets. The 25 percent limit was used when Congress first passed the RMA in a bill that was later vetoed by then-President Clinton for reasons unrelated to the RMA, but it was reduced to 20 percent for budget reasons when it was included in later legislation that was signed into law. The dividing line for testing a concentration on commercial real estate in the REIT rules has long been set at 25 percent. In addition, mutual funds are subject to a similar rule that employs a 25 percent test.

Proposal
The TRS rule would be changed to conform to these 25 percent standards.

3. Safe Harbor From Prohibited Transactions (Dealer Sales)

Background
A REIT is subject to a 100 percent tax on net income from sales of property in the ordinary course of business (prohibited transactions or

dealer sales). Because of the severity of the 100 percent 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. One of these requirements is that a REIT does not make more than 7 sales of property during the year, or that the aggregate tax bases of all properties sold during the year do not exceed 10 percent of the aggregate tax bases of all of the REIT's properties as of the beginning of the year. Another requirement is that sales of property by a REIT falling under the safe harbor must have been held for at least four years.

Unfortunately, by using a figure of 10 percent of the aggregate tax base, the law may penalize companies that are the least likely to have engaged in "dealer" activity. The most established REITs have typically held their properties the longest, resulting in low adjusted bases due to depreciation deductions. This result is inconsistent with Congress' desire to ensure that REITs own and operate property for investment purposes, but are free to engage in non-dealer market sales to benefit their shareholders. Further, a four-year holding period requirement unnecessarily restricts a REIT's ability to sell its investment properties at the most appropriate time, especially in light of the increased pace of commercial real estate sales in recent years.

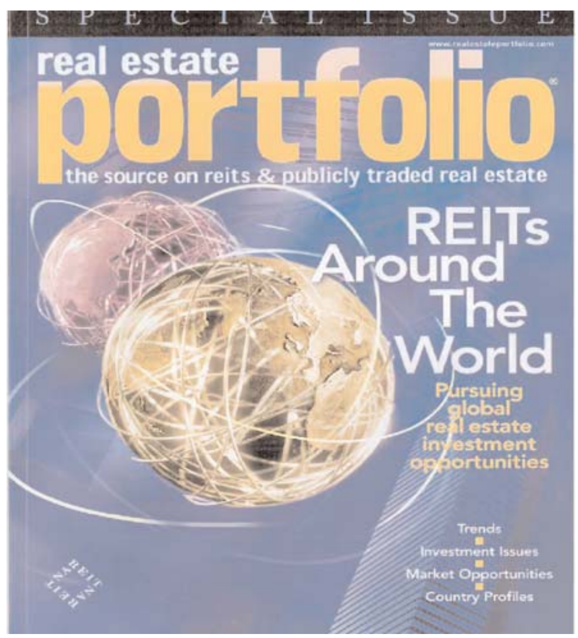
Proposals
As stated above, the safe harbor would be improved by allowing a REIT to select **either** a "fair market value" measurement or the current "aggregate bases" requirement. As part of the RMA, Congress adopted a provision that utilizes fair market value rules for other calculations. Thus, there is a precedent for this fair value approach.

Further, RIDEA would reduce the four-year holding period requirement to two years, which is more than twice the length of time required for long-term capital gain treatment and is consistent with many other investment-oriented Code sections using a two-year period.

4. Conformity of Treatment of Health Care Facilities to Lodging Facilities

Background
As part of the RMA, a lodging REIT may establish a TRS that can lease lodging facilities from a REIT holding a controlling interest, with the payments to the REIT considered qualified income under the REIT rules. A TRS may not operate or manage either lodging or health care facilities.

Proposal
REITs owning health care facilities, such as assisted living nursing homes, etc., would have the same TRS rules as lodging REITs. Thus, payments collected by a REIT from its TRS for renting health care facilities would be qualified income under the REIT tests. The prohibition of a TRS operating or managing lodging and health care facilities would continue.



5. Global REITs

Background
The number of countries that have adopted REIT-

like legislation this past decade has greatly accelerated, with Germany, Italy and the United Kingdom adopting REIT legislation and Canada replacing its trust rules with U.S.-like tax tests this year. The Internal Revenue Code treats stock in a U.S. REIT as a real estate asset so that it is a qualified asset that generates qualifying income for another REIT, but current law does not afford the same treatment with respect to the stock of non-U.S. REITs.

A U.S. REIT might decide to invest in another country through a REIT organized in that country. A company could lose its status as a U.S. REIT if it owns more than 10 percent of the foreign REIT's securities, even though the foreign company looks and acts exactly like a U.S. REIT.

Proposal
Stock in a listed non-U.S. REIT would be considered real estate for purposes of the U.S. REIT tests if under the laws of another country REITs are generally held to the same standard as REITs here, as determined by the IRS.

[1] *See* Private Letter Rulings 200726002, 200614024, 200414025, 200127024, 200115023, 200039027, 9630014.

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