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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

August 29, 2008

Via E-mail and Overnight Delivery

The Honorable Jerome D. Gerard
Acting Executive Director
Maine Revenue Services
24 State House Station
Augusta, ME 04333-0024

Re: LD 2074: Maine Revenue Services Study Group

Dear Acting Executive Director Gerard:

The National Association of Real Estate Investment Trusts® (NAREIT) thanks you again for the opportunity to participate in the July 29, 2008 meeting of a real estate investment trust (REIT) Study Group (Study Group), convened by Maine Revenue Services. As you know, this Study Group was convened at the request of the Joint Committee on Taxation of the 123rd Maine Legislature after its consideration of L.D. 2074.

In response to certain questions raised at the Study Group meeting, we are making this submission to supplement the original materials we submitted in July. First, we are submitting an updated list of REITs that own properties in Maine. As we noted in Study Group discussions, this data is based on a third party's review of documents filed with the Securities and Exchange Commission (SEC). Since some private REITs are not required to file with the SEC, the attachment may exclude properties owned in Maine by such private REITs. Thus, it is possible that the data is still incomplete as well as several months out of date. Second, this submission compares the REIT rules applicable to REITs that invest in timberlands (timber REITs), REITs that invest in hotels and motels (lodging REITs), REITs that invest in certain health care properties and REITs that invest in properties other than timber, health care and lodging properties (other REITs).

I. Generally

As further described below, all of the REIT rules of the Internal Revenue Code of 1986 (the Code, and unless otherwise provided, "section" shall be a section thereof), including the gross income tests, asset tests, distribution tests, etc., generally apply to all REITs, with minor exceptions. Those minor exceptions are described in more detail below.

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A. Gross Income Tests

For example, all REITs must satisfy two gross income tests. One test (the 75% test) requires that 75% of a REIT's gross income annually be derived from real estate related sources such as: 1) "rents from real property" (which is a defined term); 2) interest on mortgages secured by real property; 3) certain gains from the sale of real property (i.e. "non-dealer"); and 4) dividends from REITs.

The other test (the 95% test) requires that at least 95% of a REIT's gross income annually be derived from those real estate sources qualifying for the 75% test, as well as certain types of passive income, like dividends and non-real estate related interest.

In general, "rental" payments will not be considered "rents from real property" for purposes of the REIT gross income tests if the REIT owns more than a 10% interest in the tenant (the related party tenant rule). An exception to the related party tenant rule exists for rent received from a taxable REIT subsidiary (TRS) when at least 90% of the REIT's property is rented to unrelated tenants and the TRS' rent is comparable to what unrelated tenants pay. Furthermore, while charges for "customary," non-tenant-specific services (like common area maintenance) can constitute "rents from real property," charges for non-customary, tenant-specific services (like interior maid service) are excluded from the definition of "rents from real property." As a result of the REIT gross income tests, only 5% of a REIT's gross income annually may be derived from non-passive sources.

1. Timber REITs

In the case of REITs that own timberlands, the IRS has issued a number of private rulings[1] to specific taxpayers that gains attributable to the disposal of timber held for more than one year pursuant to cutting contracts under which the REIT retains an economic interest in the standing timber consistent with requirements of § 631(b) of the Code constituted qualifying REIT income under the 75% gross income test. Although these rulings cannot be relied upon by other taxpayers, they do represent the thinking of the IRS.

As part of legislation enacted this year, Pub. L. No. 110-246 (the Farm Bill), Congress made a number of clarifications and changes to some of the REIT rules applicable to timber REITs. As applicable here, Congress defined the term "timber REIT" as a REIT in which more than 50% of the value of its assets consists of real property held in connection with the trade or business of producing timber. Furthermore, Congress codified the IRS ruling that gains under § 631(b) constituted qualifying REIT income for the 75% gross income test, including gains that would have so qualified had the timber been held for more than one year by the REIT.

This legislation further stated that sales of timber under § 631(a) (if the appropriate election were made and the timber sold to a TRS) constituted qualifying REIT income for the 75% gross income test. Additionally, it provided that mineral royalty income from real property owned by a

[1] PLRs 199925015, 199927021, 199945055.

timber REIT and held, or once held, in connection with the trade or business of producing timber by such REIT, is included as qualifying real estate income for purposes of the 95% but not the 75% REIT income tests.[2]

2. Lodging and Health Care REITs

Because of the extensive services provided at both health care and lodging facilities, REITs that own these types of properties may not operate them. Congress modified the related party tenant rule for lodging REITs in 1999 (effective 2001) and for health care REITs this year. Essentially, in both cases, REITs may earn qualifying rental income from a lease of these types of properties to a REIT-owned TRS as long as the TRS hires an independent operator to operate the properties. The REIT rules include safeguards to prevent "gaming" by shifting income and deductions inappropriately to reduce the amount of tax paid by the TRS.

While these rules do not apply to REITs that lease other types of property, such REITs are typically able to operate their properties directly (since the services provided are customary and/or can be provided efficiently by a TRS) and lease such properties to third party tenants. Thus, there is no need for these rules for non-health care/lodging REITs.

B. Prohibited Transactions – Tax and Safe Harbor

1. Generally

As we discussed at the Study Group meeting, the federal REIT rules impose a 100% tax on all REITs with respect to gains attributable to property "held primarily for sale in the ordinary course of a REIT's trade or business" (also known as "inventory" or "dealer property," rather than property held for long-term investment).

2. Safe Harbor – Property Held for the Production of Rental Income

Because the penalty for selling "dealer property" is so draconian, a safe harbor is available. Specifically, under § 857(b)(6)(C), the 100% tax is not imposed on a REIT's property sales if the REIT has: 1) held the property for at least 2 years for the production of rental income; 2) not spent, in the form of capital expenditures, more than 30% of the net selling price of the property over the last 2 years; 3) either not made more than 7 sales of property within the taxable year or provided that either (a) the aggregate adjusted bases of property sold during the taxable year do not exceed 10% of the aggregate adjusted bases of all the REIT's assets as of the beginning of the taxable year, or (b) the aggregate fair market value of property sold during the taxable year does not exceed 10% of the aggregate fair market value of all the REIT's assets as of the beginning of the taxable year; and, 4) met certain other requirements.[3]

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[2] These provisions in the Farm Bill are effective for taxable years beginning after June 18, 2008 until the last day of the first taxable year beginning after June 18, 2008.
[3] We mentioned in our earlier submission that pending federal legislation, H.R. 3221, would have affected the prohibited transaction safe harbor. That legislation in fact was enacted as Public Law No: 110-289 on July 30, 2008 (also known as the Housing Bill).

3. Safe harbor – Property Held for Production of Timber

Since the above safe harbor only applies to property held for the production of rental income, it is not applicable to sales of timberland. In order to provide such a safe harbor to sales of that type of property, Congress enacted a similar safe harbor in § 857(b)(6)(D). Specifically, under § 857(b)(6)(C), the 100% tax is not imposed on a REIT's property sales if the REIT has: 1) held the property for at least 2 years for the production of timber; 2) not spent, in the form of capital expenditures, more than 30% of the net selling price of the property over the last 2 years; 3) not spent, in the form of capital expenditures not directly related to the production of timber or preservation of timberlands more than 5% of the property's selling price; 4) either not made more than 7 sales of property within the taxable year or provided that either (a) the aggregate adjusted bases of property sold during the taxable year do not exceed 10% of the aggregate adjusted bases of all the REIT's assets as of the beginning of the taxable year, or (b) the aggregate fair market value of property sold during the taxable year does not exceed 10% of the aggregate fair market value of all the REIT's assets as of the beginning of the taxable year; and, 5) met certain other requirements.

C. Taxable REIT Subsidiaries (TRSs)

When Congress originally enacted the TRS provisions of the Code, it permitted TRS securities to comprise up to 20% of a REIT's assets (although an earlier version of the legislation had used a 25% limit). The Housing Bill increased this limit to 25% of the value of a REIT's assets that may consist of securities in TRSs. (The Farm Bill had enacted this increase only for timber REITs, and only for a limited period, but the Housing Bill essentially superseded its provisions.)

I hope that this submission responds to your questions. If you have further questions, please do not hesitate to contact me at (202) 739-9446, or dbernstein@nareit.com.

Thank you again, and best regards.

Sincerely,

Dara F. Bernstein
Senior Tax Counsel

Enclosure
Cc: Nanette Ardry, Esq. (w/enclosure)