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National Policy Bulletin

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

National Policy Bulletin

RIDEA REIT PROVISIONS ARE ENACTED

EXECUTIVE SUMMARY

This morning, President Bush signed into law H.R. 3221, the Housing and Economic Recovery Act of 2008 (the Act). The Act contains all but one provision that was contained in H.R. 1147 and S. 2002, the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA). CLICK HERE for the statutory language of the Act's REIT-related provisions. CLICK HERE for the Joint Committee on Taxation's description of such provisions.

Briefly, the Act's REIT-related provisions include: 1) reducing the holding period under the "dealer" sales safe harbor test from four years to two years; 2) changing the measurement of the 10 percent of sales permitted under the safe harbor test from current tax basis to *either* tax basis *or* fair market value (at the REIT's annual option); 3) increasing the size ceiling for taxable REIT subsidiaries from 20 percent to 25 percent of assets; 4) permitting health care REITs to use taxable subsidiaries in the same manner as hotel REITs; 5) excluding most real estate-related foreign currency gains from the computation of the REIT income tests; and, 6) providing the Treasury Department with clear authority to rule on whether a variety of items are "good" REIT income. Unlike an earlier version, these provisions are permanent and do not "sunset" after five years.

DETAILED DESCRIPTION OF THE ACT'S REIT LAW CHANGES

Prohibited Transaction Safe Harbors (Dealer Sales)

Background

A REIT may be subject to a 100 percent tax on net income from sales of property in the ordinary course of business ("prohibited transactions" or "dealer sales"). In 1978, Congress recognized the need for a bright line safe harbor test for determining whether a REIT's property sale constituted a prohibited transaction. Congress further liberalized these rules in 1986 to better comport with industry practice and to simplify a REIT's ability to sell investment property without fear of being taxed at a 100 percent rate. The pre-Act safe harbor exception for rental property provided that a sale may avoid being classified as a prohibited transaction if it meets all of the following requirements:

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1) the REIT holds the property for at least four years;

2) capital improvements that the REIT made to the property during the preceding four years do not exceed 30 percent of the property's selling price;

3) (a) the REIT does not make more than seven sales of property during the year, or (b) the aggregate 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; and,

4) in the case of property not acquired through foreclosure or lease termination, the REIT held the property for the production of income for at least four years.[1]

NAREIT believed that the holding period and the measurement of the 10 percent test were outdated. As stated by Jeffrey H. Schwartz, NAREIT first vice chair and chairman and CEO of ProLogis, before the Senate Finance Committee on Feb. 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."

Jeff Schwartz, Chairman & CEO, ProLogis

Holding Period. Because of the growth of the REIT industry, in combination with the fact that investment real estate has been increasingly recognized as 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 rely on the safe harbor have been precluded from selling some of their investment assets at the most appropriate time because of the current four-year requirement, which has 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, and the two-year holding period to distinguish whether the sale of a home is taxable because it is held for investment purposes.[2]

Measurement of 10 Percent 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 percent of all the REIT's properties at the beginning of the year), many REITs could not use the safe harbor; as a result, these companies' ability to responsibly manage their property portfolio was impeded. The "seven sales" requirement was impractical because many REITs own well in excess of 100 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 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 or amortization deductions. Thus, the aggregate bases of all the REIT's properties are relatively much lower for purposes of the safe harbor exception than for a REIT that routinely turns over its properties every four years. Accordingly, a REIT that holds its properties for the longer term was penalized.

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. Thus, there was a close precedent for a fair value approach.

The Act

The Act changes the dealer sales safe harbors by: 1) reducing the holding period requirement from four years to two years; and, 2) allowing a REIT to measure the 10 percent limit by either continuing to use tax bases or instead using a "fair market value" measurement. The legislative history for RIDEA suggests that a REIT's election to use tax bases or fair market value is made 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 percent of its portfolio. Current law measures the 10 percent level by reference to the REIT's tax basis in its assets. H.R. 1147 instead would measure the 10 percent level by using fair market value. To allow a REIT to maximize its sales under the safe harbor (and thereby generating 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."[3]

Raising Taxable REIT Subsidiary Limit

Background

As originally introduced in 1999, the 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 retained when Congress first passed the RMA as part of another bill later vetoed by President Clinton for reasons unrelated to the RMA. However, the limit was reduced to 20 percent when Congress enacted the RMA as part of the Ticket to Work Incentives Improvement Act of 1999.

The Act

The Act increases the limit on TRS ownership to 25 percent of gross assets, as originally contemplated in the RMA. The rationale for a 25 percent 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 percent. Notably, the mutual fund rules continue to use a 25 percent asset test.[4]

Conforming the Treatment of Health Care Facilities to Lodging Facilities

Background

Generally, payments made from a subsidiary owned by a REIT to that REIT are not considered qualified income for REIT purposes under the "related party rules." However, as part of the RMA, a lodging REIT is allowed to 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. The RMA also created a rule under which a TRS is not allowed to operate or manage lodging or health care facilities.

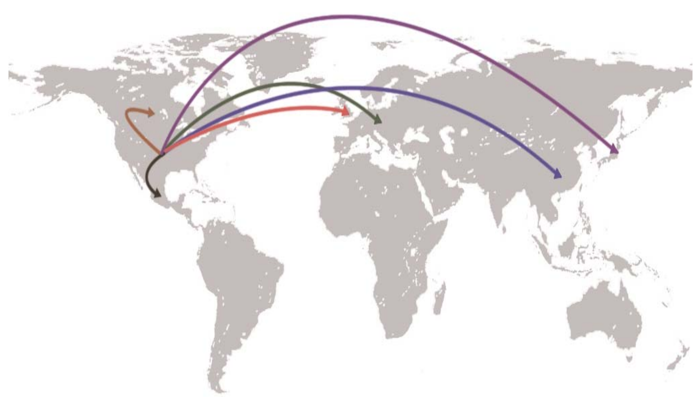
At the time the RMA was considered, health care REITs did not request the treatment sought by lodging REITs; therefore, health care facilities pre-Act did not qualify for the RMA exception to the related party rules. At the present time, many operators of health care assets, such as assisted living facilities, prefer not to bear the lessee's financial risk and would rather act purely as an independent operator of the facilities. As a result, most health care REITs now believe that the pre-Act TRS restriction interfered with their ability to oversee their property ownership interests in the most efficient manner.

The Act

The Act creates 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 independent contractor to manage or operate health care facilities, but payments collected by a REIT from its TRS in connection with renting health care facilities will now be qualified income under the REIT tests.

The Act also makes some helpful clarifications of current law. First, it clarifies that the mere possession by a TRS of a license to operate a health care or lodging facility does not violate *per se* the prohibition on operating such facilities, so long as an independent contractor in fact operates the facility. For example, a TRS will not be deemed the operator of a 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 clarifies that a TRS does not violate the prohibition of operating a lodging or health care facility if, for such facility, it is considered under local labor laws to be the employer of the employees working at such facility, so long as an independent contractor is responsible for the daily operations of the facility.



Foreign Currency Gains

Background

In general, federal tax law requires that a REIT meet specific tests regarding the composition of its gross income and assets. Specifically, 95 percent of its annual gross income must be from specified sources such as rents, dividends and interest, and 75 percent of its gross income must be just from real estate-related sources. Similarly, at the end of each calendar quarter, 75 percent of a REIT's assets must consist of specified "real estate" assets. Consequently, REITs must derive a majority of their gross income from the investment real estate business.

Failure to meet these tests can result in loss of REIT status, although with the enactment of the REIT Improvement Act in 2004, 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.

In 2003, NAREIT began a dialogue with the Internal Revenue Service and the Treasury Department about how foreign currency gains 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. 2007-33, 2007-21 I.R.B. 1281 and Notice 2007-42, 2007-21 I.R.B. 1288. Essentially, this IRS guidance concluded that foreign currency gains generate "good income" under the REIT income tests to the extent that the gains are attributable to assets that produced qualifying REIT income. However, the guidance for the most common type of foreign currency gains was labeled "interim" because it was based on proposed regulations outside of the REIT area.

The Act

Although the Act addresses the treatment of foreign currency gains for purposes of the REIT income tests, it uses a different approach and also excludes qualifying gains from the tests altogether rather than treat them as qualifying income. The basic rule is that foreign currency gains of a business division of a REIT (in tax terms, a qualified business unit or QBU) are ignored under the REIT income tests if the QBU satisfies the 75 percent income and 75 percent asset tests on a stand-alone basis.

The Act also: 1) conforms the prior REIT hedging rule to also apply to foreign currency gains; 2) extends the prior REIT hedging rule to also apply for purposes of the 95 percent gross income test (as well as the 75 percent gross income test under prior law); 3) treats foreign currency as cash or cash items for purposes of the REIT asset tests if the QBU uses the foreign currency as its functional currency; and, 4) makes conforming changes to other REIT provisions reflecting foreign currency gains.

Other Items of REIT Income

Background

Questions have arisen because certain types of income are not mentioned specifically in the 95 percent or 75 percent gross income baskets discussed above, 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, 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.[5] Unfortunately, these rulings cannot be relied on by other taxpayers and in any event do not cover all circumstances. 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."[6]

The Act

The Act expressly provides the Department of the Treasury the authority to issue guidance on other items of income to either qualify under the 75 percent and 95 percent gross income tests or to provide that items of income are not taken into account in computing those tests. Note that legislative history[7] 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 considered qualifying REIT income or income that is not taken into account for purposes of the gross income tests.

Effective Dates

The general effective date for the Act's REIT provisions is taxable years beginning after the date of enactment (*i.e.*, July 30, 2008). However, 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 rules. It is unclear how the new 10 percent measurement under the dealer sales rules will be applied for sales closed in the remainder of 2008.

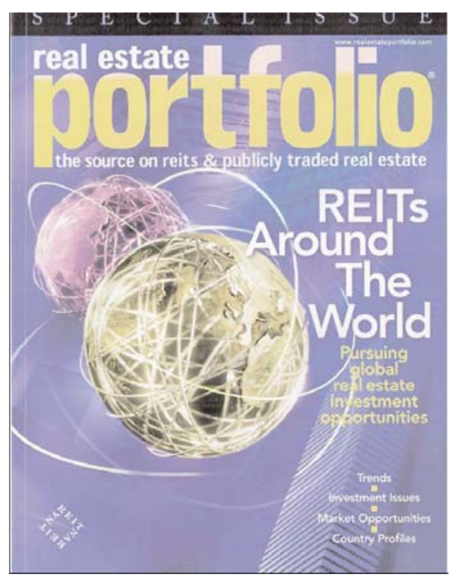
Further, legislative history provides that the Act's foreign currency rules will replace the prior IRS guidance when the foreign currency gains satisfy the Act's tests.[8] Thus, post-enactment foreign currency gains that would been treated as good income under the REIT income tests under Notice 2007-42 are now excluded from both the numerator and denominator used to calculate the REIT income tests.

REMAINING RIDEA ISSUE

Foreign REITs

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 and other countries expected to follow suit by the end of this year. Although the tax 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 percent of the foreign REIT's securities, even though the foreign company looks and acts like a U.S. REIT. 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.

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 percent 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 required to distribute at least 85 percent 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.

Outlook

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

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[1] As part of the Jobs Creation Act of 2004, similar rules were established for the sale of timberland.

[2] *See* Internal Revenue Code of 1986 (the Code) section 121 (2-year holding period for exclusion on gain from sale of principal residence); section 267 (related party matching income/expense rule does not apply if 2-year holding period met); section 382(c) (net operating loss carry forwards allowed if 2-year holding period met); section 422 (incentive stock option treatment allowed if stock underlying option held for 2 years after option grant); section 453/1031(f) (related party anti-abuse acceleration of income rule does not apply if 2-year holding period met); section 1031(h)(2) (predominant use of property determined per a 2-year holding period; section 5881 (greenmail tax does not apply if hostile shareholder held corporation's stock for at least 2 years). *Cf.* Treas. Reg. § 1.707-3(d) (disguised sale rules do not apply to transfers more than two years apart).

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

[4] Code section 851(b)(3)(B).

[5] *See, e.g.*, PLRs 200614024 and 200528004 (refunded state tax credits); 200414025 (guarantor substitution payment), 200127024 (merger and acquisition break-up fee); 200115023 (gross income from section 481 adjustment); 200039027 and 9636014 (litigation settlement fees).

[6] *See* PLRs 200821020, 200726002, 200550025, 200550017, 200550010, 200519007, 200532015, 200531013, and 200548004.

[7] 153 Cong. Rec. E384 (Daily Digest, Remarks of Representative Joseph Crowley Feb. 16, 2007).

[8] Technical Explanation of Division C of H.R. 3221, the "Housing Assistance Tax Act of 2008" As Scheduled for Consideration by the House of Representatives on July 23, 2008, JCX-63-08 (July 23, 2008) at pages 44-45.