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national policy
bulletin

National Association of Real Estate Investment Trusts®

TECHNICAL CORRECTIONS LEGISLATION INTRODUCED: WOULD FAVORABLY AMEND SEVERAL 2004 REIT PROVISIONS

Executive Summary

On July 21, 2005, House Ways and Means Committee Chairman Bill Thomas (R-CA) introduced H.R. 3376, and Senate Finance Committee Chairman Chuck Grassley (R-IA) and Ranking Member Max Baucus (D-MT) introduced S. 1447 as a companion bill in the Senate (the Tax Technical Corrections Act of 2005 or the TTCA 2005). CLICK HERE for the Joint Committee on Taxation description of this legislation. As further described below, the TTCA 2005 contains a number of significant changes to the export tax reform bill entitled the American Jobs Creation Act of 2004 (Jobs Act), which itself contained the NAREIT-supported REIT Improvement Act of 2003 (RIA). Further, the TTCA 2005 considerably expands the technical corrections applicable to REITs that were contained in the Tax Technical Corrections of 2004, H.R. 5395.

By way of background, the RIA contained a number of REIT-favorable provisions. First, it allows a REIT to make certain loans in the ordinary course of business without the risk of losing REIT status. Second, it substantially conforms the treatment under the "FIRPTA" rules of foreign shareholders in publicly traded REITs to that of foreign shareholders in other publicly traded U.S. companies. Finally, its "REIT Savings" provisions allow REITs to avoid REIT disqualification for non-intentional REIT test violations either by, among other things, remedying the violation and paying a monetary penalty if the violation was due to reasonable cause or, for certain *de minimis* violations, by bringing themselves into compliance with the REIT rules.

NAREIT appreciated Congress' leadership in enacting the Jobs Act. However, because certain provisions of the Jobs Act, particularly some of the effective date provisions, could have resulted in retroactive REIT disqualification and/or considerable additional expense for REITs that complied with prior law or comply with the new law, following the passage of the Jobs Act on October 22, 2004, NAREIT began a dialogue with policymakers seeking the enactment of certain technical changes to prevent such disqualification and/or additional expense.

On January 31, 2005, NAREIT submitted written comments to the tax-writing committees suggesting certain technical changes to the RIA provisions in the Jobs Act. As further described below, we are pleased to report that the TTCA 2005 (see H.R. 3376 at pages 15-22 and 29-30) addresses all of the RIA issues NAREIT

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originally raised with policymakers favorably. Because comments are due to the tax-writing committees on August 31, 2005, please let Dara Bernstein know at dbernstein@nareit.com if you have any comments with respect to the TTCA 2005 by close of business August 22, 2005. We are particularly interested in whether the REIT-related language in the TTCA 2005 is sufficient to provide "clean" opinions, assuming the legislation is enacted.

Discussion

Transition Rule for Expansion of the "Straight Debt" Safe Harbor

Background - In general, a REIT may not own more than 10% of the value of any other entity's securities other than those of a taxable REIT subsidiary (TRS) or another REIT. Prior to enactment of the Jobs Act, an exception to this rule existed for securities that met the definition of "straight debt," and, in the case of "straight debt" securities issued by a partnership, the exception required (at least for REITs that held non-straight debt partnership securities) that the REIT own at least a 20% profits interest in a partnership. Unfortunately, this straight debt definition did not apply to many situations in which individuals and/or businesses owed some debt to a REIT, including non-abusive loans issued in the ordinary course of business. For example, a REIT that loaned a tenant money payable out of cash flow to make leasehold improvements could have ended up with more than 10% of the tenant's total debt obligations, technically resulting in a loss of REIT status.

Jobs Act Change and Technical Issue - Retroactively effective to 2001, the Jobs Act exempts from the 10% test categories of loans that are non-abusive and presented little or no opportunity for the REIT to participate in the profits of the issuer's business. The Jobs Act also eliminated the requirement that a REIT hold a 20% profits interest in a partnership, but included a limitation that could disqualify from the new "straight debt" safe harbor otherwise qualifying debt securities if the REIT owned non-qualifying debt securities in the partnership with a value in excess of 1% of the partnership's outstanding securities. The Jobs Act also included a new safe harbor for partnership debt securities that prospectively treats them as qualifying "safe harbor" securities if at least 75% of the partnership's gross income is from the "real estate-related" sources described in Code section 856(c)(3) (such as mortgages and rents). While in general NAREIT applauded these changes, NAREIT was concerned that the retroactive change concerning partnership debt could have resulted in retroactive failures of the asset test for REITs that had complied with the provisions of the prior straight debt safe harbor.

TTCA 2005 Creation of a Transition Rule - In general, the TTCA evidences the intent to make the Jobs Act's revisions to the prior law "straight debt" safe harbor apply prospectively only to the extent that the Jobs Act provisions are stricter than prior law. The TTCA 2005 would clarify that securities of a partnership that are held by a REIT on or after October 22, 2004, and that would have qualified and continue to qualify as straight debt of that partnership under prior law rules that required a REIT to hold at least 20% of the partnership equity, will continue to so qualify while held by that REIT (or successor) until the earlier of the disposition or the original maturity date of the securities.

One potentially outstanding issue regarding this change is that the TTCA 2005 requires that the securities have been held by the REIT on October 22, 2004, and continuously thereafter. However, the TTCA did not otherwise change the Jobs Act's retroactive amendment to the prior law "straight debt" exception. As a result, it would appear that it still may be possible for a REIT that held a 20% profits interest in a partnership, along with other qualifying and non-qualifying debt securities, and which met the pre-Jobs Act "straight debt" safe harbor prior to its retroactive change by the Jobs Act on October 22, 2004, <u>but which disposed of the non-qualifying securities prior to October 22, 2004</u> to face retroactive disqualification. We would be interested in comments on this issue.

Another potential issue, which may be only theoretical, stems from the requirement that the TTCA 2005 appears to require a REIT that potentially faced retroactive disqualification under the Jobs Act due to its ownership of a 20% profits interest in a partnership in which it also held nonqualifying debt securities to continue to own a 20% profits interest following the enactment of the Jobs Act. Following enactment of the Jobs Act on October 22, 2004, REITs that faced this retroactive disqualification may have disposed of their 20% partnership profits interest shortly after enactment of the Jobs Act (assuming that any modification to the retroactivity issue raised by NAREIT would be solved only retroactively), thereby potentially eliminating their ability to meet the TTCA 2005's transition rule.

<u>Clarification of Effective Date of Conformity with the General Hedging Definition</u>

Jobs Act Change and Technical Issue - The Jobs Act modified the prior law's rule concerning the treatment of income from "hedging transactions" so that, for purposes of the REIT gross income tests, such income would be disregarded, rather than considered "qualifying" income. It also expanded the definition of "hedging transactions"by conforming the definition in the REIT provisions to that contained in section 1221. Although the Jobs Act change technically applied to taxable years beginning after October 22, 2004, the regulations under section 1221 required that a "hedging transaction" be identified by the close of the day in which it was entered into. As a result, it was possible that REITs could have faced issues with respect to satisfying their gross income tests due to failure to identify hedging transactions as such in taxable years before October 22, 2004.

TTCA Change- The TTCA would clarify that the Jobs Act's hedging change applies to transactions (*i.e.*, hedges) entered into in taxable years beginning after the date of enactment.

<u>Modification of Effective Date and Other Rules Regarding Change to Foreign Investors in REITs</u>

Jobs Act Provisions - Prior to the Jobs Act, the "Foreign Investment in Real Property Tax" (FIRPTA) required a foreign investor who received a REIT capital gain distribution to file a U.S. tax return as though the investor were doing business in the U.S and, if the investor was taxable as a corporation for U.S. tax purposes, possibly to pay a "branch profits tax." Furthermore, the REIT was required to withhold a 35% tax on such distribution. The Jobs Act modified this rule to treat a capital gain distribution of a publicly traded REIT to a non-U.S. investor as an ordinary dividend so long as the investor owns 5% or less of the distributing REIT "at any time during the taxable year." Consequently, the investor is not required to file a U.S. tax return, the branch profits tax does not apply, and the distributing REIT withholds tax at a 30% rate or a lower rate set by a bilateral tax treaty or Code section 892. The change applied to taxable years beginning after October 22, 2004.

Technical Issues Under the Jobs Act - Two technical issues were raised by these provisions. First, it was not clear whether the effective date applied to the REIT's taxable year beginning after October 22, 2004 (thus, generally to distributions made after January 1, 2005) or to the shareholder's taxable year beginning after October 22, 2004 (thus, potentially to distributions made to shareholders any time after October 22, 2004 if their taxable years began after that date). Second, because the Jobs Act required that a non-U.S. shareholder not own more than 5% at any time during the taxable year, it would be difficult for the REIT to determine whether a shareholder owned more than 5% of the REIT after the date of the capital gain distribution but before the end of the taxable year.

TTCA 2005 Changes- The TTCA 2005 clarifies that the period of time during which a foreign shareholder may not have held more than 5% of a REIT's stock is the one-year period ending on the date of distribution (rather than the shareholder's taxable year). Furthermore, the TTCA clarifies that the FIRPTA change applies to any distribution of a REIT that is treated as a deduction of a REIT for taxable years beginning after date of enactment.

The TTCA 2005 did not make the change NAREIT requested concerning a deficiency dividend paid with respect to year prior to 2005. Because deficiency dividends are treated as deductions in the year in which they relate (that is, the year in which the REIT failed to satisfy the distribution test), it is theoretically possible that a REIT could make a deficiency dividend including capital gain distributions after October 22, 2004, that relates to a taxable year that began prior to October 22, 2004. Please let us know whether this issue is substantial enough that would prevent a "clean" opinion to be issued about the non-FIRPTA status of REIT capital gains distributions paid starting in 2005.

<u>Clarification that REIT Savings Provisions Allow "Cure" of Certain *De Minimis* Asset Test Violations</u>

Violations of Asset Tests Under Prior Law - Prior to the enactment of the Jobs Act, violations of certain so-called "death trap" provisions in the REIT rules could have resulted in the disqualification of the REIT. For example, a REIT must satisfy a number of REIT asset tests at the end of each calendar quarter lost REIT status. In general, a REIT may not own more than 10% of the total voting power or 10% of the total value of the outstanding securities of any issuer (the 10% tests); not more than 5% of a REIT's assets may consist of the securities of any one issuer (the 5% test); not more than 20% of the value of a REIT's total assets may be represented by securities of one or more taxable REIT subsidiaries (TRSs) (the 20% test); at least

75% of the value of the REIT's total assets must consist of certain real estate assets and cash items (the 75% test); and not more than 25% of the value of a REIT's assets may be represented by "securities" (the 25% test).

Jobs Act Change - Under the Jobs Act, REIT asset tests are divided between *de minimis* asset test violations (failures of the 5% and 10% asset tests due to the ownership of assets that do not exceed the lesser of 1% of the trust's assets at the end of the relevant testing quarter and $10 million), and non-*de minimis* asset test violations (failures due to the ownership of assets in excess of the *de minimis* standard). Under the Jobs Act, the REIT can avoid disqualification it meets a two-part process. First, for *de minimis* asset test violations, the REIT must dispose of assets in order to satisfy the 5% and 10% asset tests within six months of discovery of the overage(s), or otherwise comply with such tests. The REIT need not show "reasonable cause" for a *de minimis* asset test failure. Second, for non- *de minimis* asset test failures, the REIT must dispose of assets or otherwise bring itself into compliance with the REIT asset tests within six months of the discovery of the violation(s), pay a tax equal to the greater of $50,000 or the highest corporate tax rate multiplied by the net income from the assets, and the failure(s) must be due to "reasonable cause."

Technical Issue Relating to the 20%, 25% and 75% Asset Tests - The Jobs Act could be interpreted to mean that there are no "cure" provisions in the Act for *de minimis* violations of the 20%, 25%, or 75% asset tests. Accordingly, a REIT that violated one of these provisions in a significant way would have the opportunity to cure the violation and pay a penalty, while a REIT that violated one of these provisions in a minor way could face REIT disqualification.

TTCA 2005 Changes Regarding De Minimis Failures of the 20%, 25% and 75% Asset Tests - The TTCA clarifies that the REIT may cure *de minimis* failures of these asset tests by disposing of assets or otherwise bringing itself into compliance with the REIT asset tests within six months of the discovery of the violation(s) and paying a tax equal to the greater of $50,000 or the highest corporate tax rate multiplied by the net income from the assets. In addition, unlike *de minimis* violations of the 5% and 10% asset tests, the REIT must have reasonable cause for the violation(s).

We are very interested to hear from NAREIT members if they believe that the TTCA clarification is sufficient to concretely resolve this interpretation issue.

<u>Clarification Regarding Effective Date of REIT Savings Provisions Applicable to Violation(s) of Any REIT Requirements</u>

Violation of REIT Tests Under Prior Law - Prior to the Jobs Act change, in addition to potential disqualification from violation of one or more REIT asset tests described above, disqualification could occur if a REIT failed any of the other tests relating to its organizational structure, its sources of gross income, the distribution of its income, its annual elections of the IRS, the transferability of its shares, etc.

Jobs Act Change - In addition to the Jobs Act provisions relating to failures to satisfy the asset tests as described above, the Jobs Act also imposes a monetary penalty of $50,000 in lieu of disqualification for each reasonable cause failure to satisfy the other REIT tests. Intentional violations continue to result in REIT disqualification.

Effective date of Jobs Act Change - The effective date of the REIT Savings provisions in the Jobs Act, both for violations of the REIT asset tests and for other REIT test violations, was for "taxable years beginning after the date of enactment" This language could be interpreted to mean that if in 2006, a REIT found a problem with respect to any of REIT requirements relating to 2004 or earlier, the REIT Savings provisions would not apply, Accordingly, NAREIT requested that the REIT Savings provisions be amended to apply to failures "discovered" in taxable years after date of enactment of the Jobs Act.

TTCA 2005 Change to the REIT Savings Effective Date -The TTCA 2005 would amend the effective date for the REIT Savings provisions of the Jobs Act to apply to failures of the REIT tests with respect to which the requirements of the new rules are satisfied after October 22, 2004 (that is, meets the reasonable cause standard if applicable, pays the penalty if applicable, and disposes of assets or otherwise brings itself into compliance). This change appears to mean, for example, that the new REIT Savings provisions apply starting in 2005 when a REIT **discovers** an asset violation and then undertakes to cure it, which is what NAREIT had requested.

Please provide comments to Dara Bernstein at dbernstein@nareit.com regarding whether this language is clear enough guidance to allow REITs to rely on this interpretation.

Clarification Regarding Effective Date of Deficiency Dividend Provisions

Deficiency Dividends Under Prior Law- The deficiency dividend provisions allow a REIT to pay a "deficiency dividend" in a later year in order to remedy a failure to distribute the correct dividend amount in a prior year resulting from a "determination." Prior to the Jobs Act, a "determination" consisted of a Tax Court decision, a closing Agreement, or another agreement signed by the Secretary of the Treasury.

Jobs Act Change - The Jobs Act amends amended the deficiency dividend provisions to allow a REIT's unilateral identification of a distribution error to be considered a "determination."

Effective date - The deficiency dividend change in the Jobs Act was effective for "taxable years beginning after the date of enactment." Because it was not clear whether this language would permit a REIT to utilize the new deficiency dividend procedures for distribution errors prior to date of enactment but remedied after date of enactment, NAREIT requested, NAREIT requested that any technical corrections legislation clarify that the provision applied to determinations made after October 22, 2004.

TTCA 2005 Changes Deficiency Dividend Provisions of the Jobs Act -The TTCA 2005 would clarify that the new deficiency dividend rules apply to statements filed with the IRS in taxable years beginning after October 22, 2004. Thus, these provisions would appear to apply to distribution errors made prior to October 22, 2004, but discovered thereafter. However, we would be interested in comments on this interpretation as well.

Issues Not Addressed by the TTCA

The TTCA 2005 did not include any changes subsequently raised by NAREIT with respect to whether timber REITs can rely on facts and circumstances if the requirements of the new timber safe harbor from prohibited transactions are not met. Further, the TTCA also did not make any changes to new Code section 470, including whether a REIT is considered a "pass-through entity."

Outlook

Typically, tax technical corrections legislation is incorporated into a larger tax bill. It is not clear when the TTCA 2005 will be passed as part of another tax bill, but it may occur as soon as this fall. In the past, the IRS has interpreted tax legislation consistent with a technical corrections bill even before the technical corrections bill is formally enacted.

Comments Sought

Once again, please provide any comments concerning the TTCA 2005 to Dara Bernstein at dbernstein@nareit.com by close of business on August 22, 2005.

For further information, please contact Dara Bernstein, dbernstein@nareit.com or Tony Edwards, tedwards@nareit.com.