May 16, 2012

Detailed Description of the Provisions in the Update and Streamline REIT Act Introduced in the House of Representatives

I. <u>Improvement in Asset Management Capabilities: Modification of Dealer Sales Safe Harbor</u>

A. *Background*

1. Dealer Sales Safe Harbor: Rental Properties.

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 current law safe harbor exception for rental property provides that a sale may avoid being 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 percent of the property's net selling price (30 Percent Rule);

2) a) the REIT did not make more than seven sales of "property" during the year (Seven Sales Rule) or b) either i) the aggregate adjusted bases of all "properties" sold during the year do not exceed 10 percent of the aggregate bases of all of the REIT's assets as of the beginning of the year, or ii) the fair market value of all "properties" sold during the year does not exceed 10 percent of the fair market value of all of the REIT's assets as of the beginning of the year (10 Percent Rule)[1]; and,

3) if the REIT is relying on the 10 Percent 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).

2. Dealer Sales Safe Harbor: Timber Properties.

A similar safe harbor enacted in 2004 (the Timber Property Safe Harbor) applies in the case of timber property. Although the Timber Property Safe Harbor is generally similar to the Rental Property Safe Harbor, the Timber Property Safe Harbor reflects some refinements as compared to the existing Rental Property Safe Harbor as well as some distinctions presumably based on the differences between timber property and rental property.

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[1] Congress enacted the flexibility to measure the 10 percent of sales by either adjusted tax basis or value in 2008 as part of the REIT Investment Diversification and Empowerment Act.

Specifically, it limits to 5 percent the capital expenditures that can be incurred for non timber-related purposes (the 5 Percent 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 Percent Timber Rule. However, the Timber Property Safe Harbor generally limits other timber-related capital expenditures undertaken in the two years preceding sale to 30 percent of the property's net selling price.

Unlike the Rental Marketing Rule, the Timber Marketing Rule had temporarily permitted (through December 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.

B. *Issues*

1. **The 10 Percent Rule**. The inflexibility of the 10 Percent Rule sometimes prevents REITs from prudently managing their assets to achieve long term growth. Except on rare occasions when it can rely on the Seven Sales Rule, a REIT can qualify for the dealer safe harbors only if it sells no more than 10 percent of its portfolio annually. This limit has the unintended consequence of preventing a REIT from repositioning its assets by selling those that are not core to its business plan and then reinvesting the sales proceeds by acquiring or developing other properties that have greater prospects for return over the long term. Nevertheless, it is understandable that the safe harbor includes reasonable limits on REIT property sales, and a minor modification of the limit would preserve those limitations while giving REITs greater management flexibility.

2. **Marketing of Property Sales**. Although Congress created TRSs in 1999 to permit taxable subsidiaries of REIT to engage in business activities that are not permitted by the parent REIT, both the Rental Property and the Timber Property Safe Harbors require that property sales be managed through an independent contractor. This rule could lead a REIT directly approached by a potential buyer to have to engage a property broker to handle the sale notwithstanding that doing so serves no practical purpose whatsoever. It would be more efficient for a TRS to handle the sale without in any way undermining the purpose of the safe harbor. Timber REITs were permitted to conduct marketing activities through their TRSs under a temporary provision enacted as part of the 2008 farm bill (the Housing Assistance Tax Act of 2008) that was not renewed at the end of 2010 along with other expiring tax provisions.

3. **REIT Property Development**. Although a REIT is permitted to develop a property that it owns without causing dealer status, the current Rental Property Safe Harbor includes language that does not permit such property to be considered under the dealer safe harbor, even if developed by the REIT decades earlier. Any concern that a REIT could develop and then promptly sell properties is fully addressed by the 30 Percent Rule. At the very least, the safe harbor should allow the safe harbor to apply if the property being tested was constructed by a TRS in addition to an independent contractor.

4. **Definition of Inventory Property**. The 2008 farm bill also included a temporary change to the timber REIT rules clarifying that property sales qualifying under the safe harbor cannot be considered inventory property (under section 1221(a)(1) of the Internal Revenue Code) for any other tax purpose. Contrary to the technical explanation prepared by the Joint Tax

Committee in 2008 in connection with the enactment of the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA), the RIDEA statutory language applicable to both the Rental Property Safe Harbor and the Timber Property Safe Harbor appears to provide that property sales qualify under the safe harbor only if the property is a real estate asset as well as inventory. Arguably, this interpretation could be read to imply that any property sale that qualifies under the safe harbor would be considered inventory property for all other tax purposes, e.g., for purposes of whether the relevant or similarly situated property could qualify for like-kind exchange treatment under section 1031 because the taxpayer is forced to concede that the property is in fact inventory.

C. *U.S. REIT Act*

1. **Modifications to Dealer Sales Safe Harbor.** The U.S. REIT Act would modify the 10 Percent Rule so that a REIT would have the option to calculate the 10 percent threshold over a three-year average, with a cap of 20 percent in any particular year, or to use the current safe harbor methodology. As an example, if in 2011 and 2012 a REIT sells 5 percent of its portfolio in each year, then in 2013 the REIT could sell up to 20 percent of its assets and still be within the safe harbor (5 percent + 5 percent + 20 percent divided by 3 equals 10 percent). Conversely, if in 2013 and 2014 a REIT sells 15 percent of its assets in each year, the REIT would not be able to sell more than 10 percent of its assets (*i.e.*, the current law test) to be under the safe harbor (15 percent + 15 percent divided by three equals 10 percent, so there would be no more room for sales under the new averaging test).

Second, the current Rental Property Safe Harbor would be updated so that the safe harbor would apply when the TRS of the REIT served as the developer (similar to the marketing rule change described below). Third, the U.S. REIT Act would codify earlier legislative history providing that the dealer safe harbor rules do not apply to the determination of whether property is considered inventory property for other tax purposes.

2. **Marketing Rule under the Safe Harbor and 100 percent Excise Tax on Transactions between REIT and TRS.** The legislation also would modify the current law requirement under the safe harbor that property sales occur through an independent contractor so that property could also be marketed through a TRS. In addition, a TRS would be permitted to operate foreclosure property without causing loss of foreclosure property status. Finally, the 100 percent excise tax regime under current law applicable to "redetermined" income and deductions between a REIT and its affiliated TRS would be extended to apply to any service income earned in a transaction between a REIT and its TRS that was not conducted on an arm's length basis.

Generally, the effective date for these safe harbor changes would be taxable years after the date of enactment.

II. Repeal of the Preferential Dividend Rule for Publicly Offered REITs and Extension of Mutual Funds' Interest-Related Dividends Rule to REITs

A. Background

1. **Preferential Dividends.**

Just like mutual funds, REITs are allowed a deduction for dividends paid to shareholders (the DPD) and are required to distribute annually most of their income to shareholders so long as the dividend is not 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 expressly entitled to such preference.

2. **Interest-Related Dividends.**

Under current law's "portfolio interest" exception, interest paid to a non-U.S. portfolio investor in certain U.S. debt securities (such as Fannie Mae securities) is exempt from U.S. withholding tax. As a result, it has been more tax-efficient for a non-U.S. investor to hold such securities directly rather than through a mutual fund or REIT because mutual fund and REIT dividends are typically subject to a 30 percent (or lower treaty rate) withholding tax even if attributable to interest that would have qualified for the portfolio interest exception.

In the American Jobs Creation Act of 2004 (2004 Tax Act), Congress enacted a provision essentially exempting from withholding taxes "interest-related dividends" from mutual funds to non-U.S. investors with respect to fund tax years beginning on or after January 1, 2008. In 2008, Congress extended this provision for one year. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 as signed by President Obama on December 17, 2010, extended this provision through 2011.

The 2004 Tax Act also included a temporary provision similarly exempting "short-term capital gain dividends" distributed by mutual funds to non-U.S. shareholders from U.S. withholding taxes. Under the 2004 Tax Act, the maximum amount that a mutual fund may designate as an interest-related dividend is the mutual fund's net interest income less properly allocable expenses. Legislative history to the 2004 Tax Act also indicated that a portion of a mutual fund's expenses are properly allocable to a mutual fund's short term capital gains. On the other hand, as a result of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 Tax Act), Congress enacted a lower 15% tax rate for U.S. shareholders with respect to "qualified dividend income" (QDI). Mutual funds (and REITs) may designate a portion of their dividends as QDI.[2] Unlike interest-related dividends, the maximum amount of QDI that a mutual fund or REIT may designate is a gross amount, not reduced by expenses.

Following the enactment of the 2004 Tax Act, the mutual fund industry requested that the IRS interpret the 2004 Tax Act and 2003 Tax Act as allowing them to designate the maximum amount of QDI, interest-related dividends, and short-term capital gain dividends possible under the statute,

[2] Click here for further details about REITs and the 2003 Tax Act.

notwithstanding that doing so could result in the aggregate of all of the amounts so designated exceeding the total amount of a mutual fund's dividend distributions. In Rev. Rul. 2005-31, 2005-1 C.B. 1084, the IRS adopted the mutual fund industry's position. Rev. Rul. 2005-31 also provides that individual U.S. mutual fund shareholders may apply designations to the dividends they receive from the mutual fund that differ from designations applied by nonresident alien individual shareholders.

B. Issues

1. **Preferential Dividends.**

The preferential dividend rule for REITs is redundant in light of current securities laws and not necessary to prevent tax avoidance, particularly in the case of REITs that are required to file annual and periodic reports with the SEC under the Securities Exchange Act of 1934 (1934 Act) (publicly offered REITs)[3]. The requirement in the tax law is also unnecessary given the litigation risk faced by any company that treats any shareholder differently than other shareholders of the same class. In addition, because any effort to correct an inadvertent or *de minimis* error would itself be considered a preferential dividend, even a small, immaterial "foot fault" can disqualify entire distributions from qualifying for the DPD. The consequences of preferential dividends are draconian and wildly disproportionate: a REIT can either lose REIT status or be required to pay out its earnings a second time in the form of a deficiency dividend. The existence of the tax rule requires REITs to devote a tremendous amount of time and resources to avoid foot faults.

Congress enacted the preferential dividend rule to prevent tax avoidance by shareholders of certain closely held corporations known as personal holding companies (PHCs). PHCs can effect tax avoidance by shifting dividend rights among shareholders. The preferential dividend rule prevents this income splitting means of tax avoidance.

The rationale of such a tax avoidance rule does not apply to public REITs, which have widespread ownership and no incentive or ability to minimize tax among shareholders; in fact, such REITs would typically have no way of knowing of other shareholders or their respective tax rates. Further, 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.

On December 22, 2010, President Obama signed into law H.R. 4337, the Regulated Investment Company Modernization Act of 2010, which, among other items, repealed the preferential dividend rules for publicly offered mutual funds. The Obama Administration's Fiscal Year 2012 Budget proposed to repeal the preferential dividend rules for traded REITs and to expressly provide regulatory authority to the IRS to cure inadvertent failures of the preferential dividend rules for other REITs. Its Fiscal Year 2013 Budget expands its proposed repeal to certain "publicly offered" REITs, REITs whose securities are required to be registered with the SEC under the 1934 Act.

[3] On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act that increased the number of shareholders a company must have before being required to register with the SEC from 500 to 2,000.

2. **Interest-related Dividends.**

Although mortgage REITs may offer professionally managed investment portfolios of U.S. debt securities, foreign portfolio investors in those securities bypass investing through them because of the increased tax cost. While direct investment reduces the withholding tax, investors also lose the benefit of a professionally managed portfolio.

C. U.S. REIT Act

1. **Preferential Dividends.**

Effective for distributions in taxable years beginning after the date of its enactment, the U.S. REIT Act would conform the preferential dividend rule treatment of REITs to that of mutual funds. The preferential dividend rule would not apply to "publicly offered REITs", *i.e.*, REITs that have to register their securities under the 1934 Act. Furthermore, the IRS would be given the regulatory authority called for in the Administration's 2012 and 2013 Budgets to cure inadvertent failures of the preferential dividend rules for other REITs.

2. **Interest-Related Dividends**.

Furthermore, generally effective for distributions after the date of its enactment, the U.S. REIT Act would extend to REITs the same temporary provision that would apply to mutual funds exempting interest-related dividends of a publicly traded REIT that is not 50 percent or more owned by a non-U.S. investor (assuming the tax extenders are passed this year).

Unlike the special rule applicable to mutual funds described above, the U.S. REIT Act provides that the maximum amount of its distributions that could be designated as capital gain dividends, QDI, and interest-related dividends could not exceed the distributions paid by the REIT for a particular taxable year.

III. <u>Improving the REIT Income and Asset Tests</u>

A. *Background*

Generally, in order to ensure that a REIT is real estate-focused, at least 75 percent 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 Percent Income Test), and at least 95 percent of a REIT's annual gross income must be from these sources, as well as other passive, non-real estate sources, like interest on bank deposits (95 Percent Income Test). Additionally, at the close of each quarter, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash, cash items, and Government securities (Asset Test).

B. *Issues*.

1. **REIT Debt Securities**. Although stock in a REIT is considered a "real estate asset" that another REIT may hold, unsecured debt securities of a REIT are not – even though their holders have a higher priority on the REIT assets than equity security holders. This reduces the market for unsecured REIT debt securities and raises a barrier to a REIT that wishes to invest its cash in REIT debt securities that can provide attractive yields.

2. **Associated Personal Property Leased with Real Property**. The income test treats rental income attributable to personal property leased in connection with real property (*e.g.*, kitchen appliances in an apartment) as qualifying rental income so long as the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total property rent received under the property lease for the taxable year. This rule recognizes that the tenant is really paying rent for the overall property, and the personal property is merely an accessory to the real property. However, current law does not treat such associated personal property as a "real estate asset" for purposes of the rule that 75 percent of a REIT's assets quarterly consist of, among other things, "real estate assets," thereby creating unnecessary administrative burdens.

3. **Associated Personal Property Securing Mortgage on Real Property**. Current regulations require that interest on a mortgage secured by both real and other property be apportioned between the real and other property even if the "other property" securing the mortgage is minuscule. On the other hand, these regulations are inapplicable when a mortgage is only secured by real property. In the case of an under-secured mortgage (resulting from either a debt modification or acquisition of distressed debt, *e.g.*, debt with a face amount of $100, secured by real property worth $80), the application of these rules can lead to disparate results if in one case, the mortgage is also secured by only $1 of "other property" (in which case, only 80 percent of the interest income is qualifying "real estate" income), and, in the second case, it is only secured by real property (100 percent of the interest income is qualifying real estate income). Further, a REIT may reasonably believe that the value of the "other property" securing the newly acquired distressed mortgage loan is zero, but the consequences of that conclusion being successfully challenged appear to be potentially disastrous.

4. **Gain from the Sale of Timber Property**. 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 REIT income under the 75 percent and 95 percent Income Test[4]. As part of the 2008 farm bill, the IRS rulings were codified in Section 856(c)(5)(H) on a temporary basis and expanded to cover section 631(a). The expiration of this provision, along with the existence of the prior IRS rulings, serves no policy justification and creates uncertainty for timber REITs that would be alleviated by reinstating and making permanent the temporary law.

5. **Mineral Royalty Income as Qualifying 95 percent Income**. Similarly, the 2008 farm bill included a provision which has since expired, Section 856(c)(2)(I), that temporarily treated as qualifying income under the 95 percent gross income test "mineral royalty income" earned by a

[4] PLR 201123005; PLR 201123003; PLR 200052021; PLR 199945055; PLR 199927021; PLR 199925015; PLR 8838016

timber REIT from real property held, or once held, in connection with the trade or business of producing timber.[5] This provision was enacted because income from mineral royalties is considered to be another form of passive income under the 95 Percent Income Test.

Again, the expiration of these provisions serves no policy justification. Further, there is no policy reason to limit the provision only to timber REITs; mineral royalty income is a type of passive income from property, and it should apply to all REITs.

6. **Hedging: Income from Counteracting Hedges and Failure to Identify Qualifying Hedges**. First, under current law, income attributable to certain "qualifying hedges" is not considered gross income (for purposes of the REIT gross income tests) provided the hedges are identified on the same day on which they are entered. An inadvertent failure to identify or a delay in identifying a hedge can disqualify all income from that hedge. Curative regulations exist, but, for technical reasons, they only affect the character (capital vs. ordinary) of income from a hedge. These curative regulations should be extended to allow curing inadvertent failures to identify a hedge.

Second, although income from qualifying hedges is excluded from gross income for purposes of the REIT gross income tests, if a REIT pays off a liability incurred to purchase or carry real estate, terminating a qualifying hedge that the REIT entered into to manage risk on that liability may require a significant immediate cash outlay. Consequently, the REIT would prefer to keep the hedge in place and over time make the payments due under the hedge, preferably also offsetting that hedge with a second hedge so that the REIT would have no net risk. While the current rules cause the income from the first hedge to be disregarded for REIT purposes while it hedges the liability, they do not apply to the hedge after the liability is paid off, nor do they apply to the second hedge.

C. *U.S. REIT Act*

1**.** **REIT Debt Securities**. The U.S. REIT Act would classify certain REIT debt securities as real estate assets. This section would classify debt securities of a publicly offered REIT as a "real estate asset" while limiting the amount of unsecured debt securities a REIT may own in another REIT to 25 percent of the investing REIT's gross assets.

2. **Leases and Loans with Associated Personal Property**. The U.S. REIT Act would conform REIT income and assets tests by:

(a) Treating Personal Property Leased with Real Property as a Real Estate Asset If Value Does not Exceed 15 percent of the Associated Total Value of Leased Property. The income test treats rental income attributable to personal property leased in connection with real property (*e.g.*, beds in a hotel) as qualifying rental income so long as the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total property rent received under the property lease

[5] The Joint Tax Committee has indicated that mineral royalty income was intended to include oil or gas royalty income. 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), May 28, 2010 at footnote 250.

for the taxable year. Under the U.S. REIT Act, the Asset Test similarly would treat personal property leased in connection with real property as a qualifying real estate asset; and,

(b) Treating Other Property that, in connection with Real Property, Secures a Mortgage Loan, as Real Property if Value Does not Exceed 15 percent of the Total Value of the Real and Other Property Securing the Loan. The U.S. REIT Act would treat personal property that, in connection with real property, secures a mortgage loan as an interest in real property so long as such personal property (by fair market value) does not exceed 15 percent of the total value of all property securing the loan. Such mortgage would thus be considered entirely a real estate asset, and all of the interest generated by such mortgage would be qualifying real estate income.

3. **Gain from Sale of Timber Property and Mineral Royalties**. The U.S. REIT Act would treat gain from the sale of timber as qualifying REIT income for the 75 Percent and 95 Percent income tests permanently. Furthermore, the legislation would permanently include mineral royalty type of income as qualifying 95 percent Income for all REITs and would specify that oil and gas royalties would be considered income from mineral royalties for this purpose.

4. **Hedging Rule**. Under current law, income attributable to certain "qualifying hedges" is not considered gross income provided the hedges are identified on the same day as entered into. This section would: 1) include as qualifying hedges those entered into to counteract a qualifying hedge; and, 2) for purposes of the REIT hedging rule, include hedges for which the curing regulations under section 1221 apply.

All of the above would be effective in taxable years beginning after the date of enactment.

IV. **Modification of Earnings and Profits Rule to Minimize Duplicative Taxation of REIT Shareholders**

A. *Background*

Non-residential real estate and residential real estate (*e.g.*, apartments) are depreciated on a straight-line basis over 39 years and 27.5 years, respectively. In addition, certain leasehold improvements have been deducted over 15 years, and deductions for certain energy efficient investments in commercial real estate are expensed in the year of the investment. However, for purposes of calculating a corporation's dividends – the so-called earnings & profits (E&P) calculation – real estate is written off over forty years, leasehold improvements are deducted over 39 years, and the energy efficient investments are written off over five years. Because REIT distributions to shareholders are taxable to the extent of E&P, the overstated E&P frequently results in duplicate taxation of REIT shareholders.

REITs typically determine the size of their dividends based not only on REIT distribution requirements, but also on historical practices and the amount of cash available for distribution. Therefore, REIT distributions frequently exceed taxable income. If the distributions exceed E&P as well, the excess is treated as a return of capital rather than as a taxable dividend.

B. *Issue: Mismatch Between E&P and Taxable Income Can Lead to Double Taxation*.

The following example illustrates how the mismatch can result in REIT shareholders effectively being taxed twice on the same REIT income.

Assume a REIT that has taxable income of $90, taking into account the deduction of a $10 energy efficiency expense, and distributes $100. The REIT is able to deduct only $2 from E&P in that year. As a result, the REIT's shareholders will be taxed in the year of the distribution as if $8 of the expense were not deductible from taxable income. This mismatch between taxable income and E&P is more than just a timing issue that would be resolved as the REIT claims the deferred E&P deductions in years 2 through 5 because there is a technical REIT rule that disallows E&P deductions when there is not a corresponding taxable income deduction (the E&P Disallowance Rule). Because of the E&P Disallowance rule, the $8 of deferred deductions would not reduce E&P over years 2 through 5 because there would be no corresponding taxable income deduction in those years. Consequently, when the REIT distributes its taxable income in those years, the shareholders are once again taxed on the $8.

The E&P Disallowance Rule is a necessary rule to ensure that a REIT has sufficient E&P to satisfy the requirement to distribute at least 90 percent of its taxable income as a dividend, but as it is currently written, its application can cause this doubling up of tax on REIT shareholders.

C. *U.S. REIT Act*.

In order to minimize duplicative taxation of REIT shareholders, the E&P Disallowance Rule would be modified for taxable years beginning after the date of enactment to allow for reduction of E&P by deductions that were allowable to reduce taxable income in either the current year or prior years. A conforming change would be made to a similar rule that increases a REIT's E&P solely for purposes of the DPD by the total amount of gain recognized on the sale of property (the E&P Gain Rule.)[6] As a result, this proposal would ensure that the REIT would have sufficient E&P to meet its DPD obligation while eliminating duplicate taxation of REIT shareholders.[7]

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[6] The E&P Gain Rule increases E&P, *solely for the purposes of the DPD*, by the full amount of the gain recognized by the REIT, thereby providing it sufficient E&P to support its distribution of at least 90 percent of taxable income (and, even more importantly, a distribution of 100 percent of its taxable income) as a dividend. The E&P Gain Rule ensures that a REIT that distributes at least 100 percent of its taxable income will have sufficient E&P so that the distribution is treated as a dividend eligible for the DPD.

[7] *Cf*. Temp. Treas. Reg. § 1.108(i)-1T(d)(2) (deferring cancellation of debt income realized by REITs and mutual funds until the year in which it is recognized under I.R.C. § 108(i.)