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national policy bulletin

National Association of Real Estate Investment Trusts®

REIT IMPROVEMENT ACT OFFICIALLY UNVEILED

On April 30, 2003, U.S. Representatives Jim McCrery (R-LA), Ben Cardin (D-MD) and 25 other members of the House Ways and Means Committee introduced H.R. 1890, the Real Estate Investment Trust Improvement Act of 2003 (the "RIA"). Click **HERE** for statutory language. As further described below, H.R. 1890 would: (1) exclude a range of debt instruments issued by others from a REIT's 10% "securities" ownership limitation that was modified as part of the REIT Modernization Act of 1999; (2) remove a significant barrier to foreign investors buying REIT stock; and (3) replace the loss of REIT status with monetary penalties for reasonable cause failures to meet the REIT rules.

The RIA is the result of over two years of dialogue with several legislators, the staff of the Joint Committee on Taxation, members and staff of the tax-writing committees and the Department of Treasury.

NAREIT urges all its members to: (1) call other House Members to request that they contact either Representative McCrery or Cardin to become an RIA co-sponsor (for a list of House Members check your 2003 NAREIT Congressional Handbook and for a list of Ways and Means Committee members, click **HERE**); and (2) write to Representatives McCrery, Cardin and the other original co-sponsors to thank them for their leadership in sponsoring this important legislation (click **HERE** for list of co-sponsors). A companion bill will be introduced in the Senate soon.

EXECUTIVE SUMMARY OF THE RIA

Improvements To REIT Modernization Act Of 1999 ("RMA")

For purposes of the limitation that a REIT own not more than 10% of an issuer's "securities" (including certain debt "securities"), the RIA would modify the Internal Revenue Code's definition of "straight debt", which is excluded from this limit, to also include debt the repayment of which could be conditioned upon cash flow, as well as to describe a number of specific *per se* exemptions to this asset test. The proposed language also contains technical corrections related to rent received from taxable REIT subsidiaries ("TRSs") as well as provisions that would update certain rules that apply to currency hedges.

Modifications To Treatment Of Foreign Investors In REITs

The RIA would change the current rules so that a foreign investor who owns less than 5% of a publicly traded REIT would not be treated as engaged in a U.S. business. Accordingly, such an investor would not be required to file a U.S.

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tax return solely due to a REIT's capital gain distributions or to pay a "branch profits" tax solely because of such distributions. Major money managers have advised NAREIT that substantial amounts of offshore investment, including amounts that normally would be invested in REITs to match passive indexes, are not invested in REITs because of these barriers that do not arise from investment in other U.S. equities.

Monetary Penalties In Lieu Of REIT Disqualification For Reasonable Cause Violations Of The REIT Rules

In lieu of loss of REIT status, a REIT would be assessed a monetary penalty of $50,000 for each reasonable cause failure to satisfy the REIT rules other than the asset test. For violations of the asset test, in lieu of disqualification a REIT would be given an opportunity to dispose of assets that do not exceed 1% of its total assets. Assets in excess of the 1% de minimis amount would be subject to a tax of the greater of $50,000 or the highest corporate tax rate multiplied by the net income from the assets if the violation was justified by reasonable cause.

Outlook

The RIA was the major focus of the meetings with Members of Congress conducted on March 26 as part of NAREIT's 2003 Washington Leadership Forum. NAREIT thanks the participants in the Washington Leadership Forum for their efforts in explaining the importance of these provisions to policymakers. NAREIT will continue to work with its members to secure a significant number of sponsors, especially Members of Congress on the tax-writing committees. NAREIT expects that a companion bill to H.R. 1890 will be introduced in the Senate soon. The bill's co-sponsors will attempt to include the RIA in other tax legislation the Congress will consider in 2003, including the President's jobs and growth package.

DETAILS OF H.R. 1890

Title I: Corrections To RMA

The "10% Rule"

By way of background, in 1999 Congress passed the REIT Modernization Act ("RMA") to update the rules governing REITs to permit them to own taxable subsidiaries that can engage in business operations not permitted to REITs. In exchange for authorizing this new taxable subsidiary arrangement, the RMA prohibits REITs from owning more than 10% of the vote or value of any other entity's securities, excluding "straight debt". The 10% rule was intended to prevent REITs from owning more than 10% of the equity of another corporation, other than a taxable REIT subsidiary, to prevent a REIT from interacting with the other corporation on a non-arm's length basis. However, as drafted, the 10% rule potentially applies to many situations when individuals and businesses owe some sort of debt ("security" defined broadly) to a REIT.

There are many instances in which REITs make non-abusive, ordinary loans in the course of business for which they could face loss of REIT status because the loans do not qualify as "straight debt." The most common context is in the REIT's relationship with tenants when, for example, the REIT lends the tenant money for leasehold improvements. If payable out of the tenant's cash flow, and the loan represents more than 10% of the tenant's total debt obligations and other "securities," the loan could lead to REIT disqualification although the amount owed could be quite small.

Proposed Solution

H.R. 1890 would exempt from the 10% rule certain categories of loans that are non-abusive and present little or no opportunity for the REIT to participate in the profits of the issuer's business. This includes any loan from a REIT to an individual or to a government, and any debt arising from a real property rent arrangement.

Subsidiary Rent Rule

To prevent a REIT from shifting income out of a related taxable corporation to the REIT, rent payments to the REIT from a corporation that is at least 10% owned by the REIT are treated as "bad income" rather than "good income." However, under the RMA, rent paid by a taxable REIT subsidiary (TRS) to a REIT is considered "good" REIT income so long as unrelated parties rent at least 90% of the leased space of the property, and the subsidiary pays rent comparable to that paid by unrelated parties. One problem has arisen because the rule does not contain measurement dates for determining how much of the REIT's property is rented by unrelated parties or what are comparable rates; another problem results from the absence of a grace period when leases unexpectedly terminate, resulting in an increase in the percentage of property rented to the subsidiary.

Proposed Solution

H.R. 1890 would test for comparable rents at the beginning of a lease with a subsidiary, upon a lease extension, and upon a lease renegotiation when the rent between a REIT and its subsidiary is increased. Further, the legislation would allow a REIT a full quarter to re-lease to non-TRSs when non-TRS lease terminations cause a REIT to be renting more than 10% of a property to TRSs, e.g., if a mall tenant rejects a lease through bankruptcy proceedings.

The 100% Tax Rule

The RMA imposes a 100% excise tax on income or deductions improperly shifted between a REIT and its taxable subsidiary. This rule, however, does not apply to income the subsidiary earns that is attributable to customary services the REIT itself could provide. As a result of a drafting mistake, the rule only exempts income paid by the subsidiary to a REIT, rather than income paid by the tenant to the REIT.

Proposed Solution

H.R. 1890 would delete this safe-harbor protection for a subsidiary providing customary services to a REIT's tenants. Instead, a REIT and its TRS could rely on another safe harbor under which the subsidiary must recognize as income at least 150% of the direct costs of providing services to the REIT's tenants.

REIT Gross Income Tax

To maintain REIT qualification, each year, at least 75% of a REIT's gross income must be from real estate related sources, and at least 95% of a REIT's gross income must be from real estate sources and passive income sources. A REIT that fails to satisfy either the 75% or 95% test may still be considered as having satisfied these requirements if the failure is due to reasonable cause and not willful neglect. While the REIT will not be disqualified, it will be subject to additional taxes based on the difference between its actual income and the income required under the 75% or 95% test. When the RMA was enacted it included an incorrect reference that had the effect of eliminating the tax in 856(c)(6) when good REIT income was less than 95% but more than 90%.

Proposed Solution

H.R. 1890 would correct this incorrect reference by replacing "90%" with "95%" on a prospective basis.

Other Corrections

Hedging Rules

Mortgages are a natural part of a REIT's business operations. Real estate companies have long used hedges to protect their businesses, e.g., hedging their variable rate mortgages. Hedges can produce a large amount of gross income even when offset by a corresponding amount of hedged losses. This gross income could disqualify a REIT if improperly characterized.

Before 1997, the Code provided that any amounts a REIT realized from a hedge of a variable rate mortgage would qualify as good REIT income for purposes of the 95% gross income test. In 1997, Congress expanded the rule to cover gross income from any hedge of real estate debt "to reduce interest rate risks." Since then, the IRS has issued extensive regulatory advice on hedges under the general rules of section 1221, which provides a more current definition of hedge instruments. These more up-to-date rules go beyond the types of hedge instruments defined in the REIT rules, e.g., specifically including currency hedges.

Proposed Solutions

H.R. 1890 would (a) update the REIT rules to conform to the general hedging rules of section 1221; and (b) provide that any income under a hedging transaction is disregarded for purposes of the 95% gross income test (rather than qualify as qualified income for that test as under current law).

Prohibited Transaction Rule

REITs are real estate companies whose primary business is deriving income from investment in real estate. To deter REITs from acting as dealers or traders in real estate, section 857(b)(6) of the Code imposes a 100% tax on the net income from "prohibited transactions," i.e., the disposition of property that is held for sale in the ordinary course of the taxpayer's trade or business. However, at the same time, the tax Code recognizes that in the regular course of their business operations REITs have reason to dispose of properties from time to time. Therefore, section 857(b)(6) lays out certain safe harbors to the prohibited transaction rule for property held for at least 4 years for the "production of rental income".

Unfortunately and inappropriately, the tax Code prevents timber REITs from using the existing safe harbor because their qualifying REIT income is from the sale of timber, not from the rental of real estate. Nonetheless, timber REITs are still subject to the same prohibited transaction rule, and their occasional disposal of real estate in the course of efficiently managing their properties subjects them to considerable uncertainty because the safe harbor is not available to them.

Proposed Solution

Broaden the safe harbor so that it applies to income from timber sales in addition to the "production of rental income," while limiting the amount a timber REIT can spend on "development" and still come within the safe harbor.

Effective Dates

The change to the "straight debt" and TRS rent provisions would apply to taxable years beginning after December 31, 2000, while the other provisions would apply to taxable years beginning after date of enactment.

Title II: Modifications To Treatment Of Foreign Investors In REITs

There is relatively little foreign investment in U.S. REITs today. In part, this is because U.S. money managers routinely receive assignments to place foreign investment capital in the United States under which they have complete discretion to invest in U.S. equities except that they are instructed not to invest in REITs. The reason is that under the Foreign Investment in Real Property Tax Act ("FIRPTA"), REIT capital gains distributions are treated as gains from U.S. real property interests connected to a U.S. business. This treatment is in stark contrast to another part of the tax Code that provides that FIRPTA does not apply to sales of a publicly traded REIT's stock by a foreign investor if the seller owns 5% or less of the REIT's stock.

Because foreign investors are treated as engaging in a U.S. business if they receive a REIT's capital gain distribution, these non-U.S. shareholders must file U.S. tax returns even if the 35% tax required to be withheld by the REIT on the capital gains distributions entirely satisfies the investor's U.S. tax liability. Foreign investors consider this return-filing requirement a nettlesome burden on a very minor portion of income and, therefore, instruct their U.S. money managers to avoid all REIT investments.

Compounding the return-filing issue is a more technical issue involving the so-called "branch profits" tax. The branch profits tax is intended to impose tax on a non-U.S. corporation's operation of a U.S. business through a branch as if the corporation were operating through a corporate subsidiary. An exception to the branch profits tax applies to the sale of the stock of a U.S. real property interest such as REIT stock. Despite this, the tax Code could be read as applying the branch profits tax to REIT capital gain distributions to non-U.S. corporations (which are already taxed once under FIRPTA), further discouraging foreign investment in U.S. REITs. Application of the "branch profits" tax to foreign investors in U.S. REITs would violate the intent of Congress to impose a single layer of tax on REIT shareholders, and is especially inappropriate for "portfolio investors" in publicly traded REITs.

Proposed Solution

Section 897(h)(1), which treats REIT capital gain distributions as effectively connected to a U.S. business, would be amended to treat as ordinary dividends such distributions received by foreign shareholders owning 5% or less of a REIT that is publicly traded on a U.S. exchange. As a result, the current exclusion from the branch profits tax applicable to sales of REIT stock would be expanded to include REIT capital gains distributions to such portfolio investors in these publicly traded REITs. Further, foreign investors owning 5% or less of a U.S. publicly traded REIT would not have to file U.S. tax returns merely because they receive REIT capital gains distributions. These provisions would apply to taxable years beginning after date of enactment.

Title III: REIT "Savings" Legislation

There are certain so-called "death trap" provisions in the REIT tax rules that result in the disqualification of the REIT if various requirements are not met. The loss of REIT status would be a catastrophic occurrence, one that REIT management must avoid at all costs. As a result, REIT management expends significant resources to have in place compliance and monitoring measures to avoid such a result. Additionally, if a minor breach of the rules does occur, the IRS is left with an unpalatable choice - do nothing or terminate the REIT's status. A better approach would be to build some flexibility into the REIT rules for the IRS so that monetary penalties may be imposed, in lieu of REIT disqualification, for the "reasonable cause" failure to meet certain REIT rules.

Asset Test

Under current law, a REIT is disqualified if more than 5% of its assets are comprised of the securities of any entity, or if owns more than 10% of the voting power or value of any entity other than another REIT or a taxable REIT subsidiary.

Proposed Solution

In lieu of disqualification, a REIT would be given an opportunity to dispose of (generally within six months) such interests or otherwise cure a violation that does not exceed 1% of its total assets. Assets in excess of the 1% de minimis amount would be subject to a tax of the greater of $50,000 or the highest corporate tax rate multiplied by the net income from the assets if the violation was justified by reasonable cause.

Other Tests

Under current law, a REIT is disqualified if it does not meet certain other tests relating to its organizational structure, the distribution of its income, its annual elections to the IRS, the transferability of its shares, and other requirements.

Proposed Solution

In lieu of disqualification, a REIT would be assessed a monetary penalty of $50,000 for each reasonable cause failure to satisfy these rules. These provisions would apply to taxable years beginning after date of enactment.

NAREIT will stay closely involved in the legislative process and keep you informed as this legislation evolves.

If you have any questions about these issues, please contact
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