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national policy
bulletin

National Association of Real Estate Investment Trusts®

Senate Passes "JOBS" Bill with Two REIT Improvements

Yesterday, the Senate approved S. 1637, the "Jumpstart Our Business Strength (JOBS) Act." The JOBS Act would significantly reform the way the United States taxes domestic taxpayers operating abroad and foreign taxpayers operating and investing in the United States. The JOBS Act also is known as the "FSC/ETI Bill" because it would modify the FSC/ETI (foreign sales corporation/extraterritorial income) tax provisions of the Tax Code.

As described below, S. 1637 incorporates two provisions contained in S. 1568, the NAREIT-supported Real Estate Investment Trust Improvement Act of 2003 (RIA). Title II of the RIA would modify in most cases the requirement that foreign portfolio investors in publicly traded REITs file a tax return after receiving a capital gain distribution from a REIT. S. 1637 also includes a provision from Title I of the RIA that would clarify that timber REITs could use a safe harbor so that certain transactions would not be treated as dealer sales subject to a 100% tax rate.

The remainder of Title I of the RIA, which would allow, among other things, a REIT to make certain loans in the ordinary course of business without the risk of losing REIT status, is incorporated in the FSC/ETI bill passed last fall by the House Ways and Means Committee, H.R. 2896.

Neither S. 1637 nor the companion Ways and Means Committee bill yet incorporate Title III of the RIA, which would allow REITs to avoid REIT disqualification for non-intentional REIT test violations either by paying a monetary penalty if the violation was due to reasonable cause or, for certain *de minimis* violations, bringing themselves into compliance with the REIT rules. For more information on the RIA, CLICK HERE.

SUMMARY OF THE RIA PROVISIONS IN THE SENATE JOBS BILL

Modifications to Treatment of Foreign Investors in REITs: Title II of the RIA

Title II of the RIA would remove a major barrier to non-U.S. investment in publicly traded U.S. REITs. Under current law, foreigners who receive REIT capital gain dividends are treated as operating a business in the United States and therefore must file U.S. tax returns even if they have no other U.S. tax obligations. Further, foreign institutions that receive REIT capital gains distributions possibly are subject to another layer of U.S. taxes under the so-called "branch profit" taxation rules.

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Treating foreign REIT investors as if they operated a U.S. business is inconsistent with how foreign investors in other publicly traded companies are treated under U.S. tax law as well as the other tax rules affecting REITs. Generally, the United States requires a non-U.S. shareholder receiving a dividend from a U.S. corporation to incur U.S. withholding tax, but not to file a U.S. tax return. Also, the U.S. does not tax a non-U.S. shareholder that sells shares of a U.S. corporation. Although the U.S. does impose tax on foreigners' sales of shares in U.S. real estate corporations, no tax is imposed on the sales of shares of a publicly traded real estate company (including a REIT) if the investor owns 5% or less.

S. 1637 would treat REIT capital gains distributions the same as ordinary dividends so long as: (1) the shares of the REIT are publicly traded on a U.S. securities market; and (2) the shareholder receiving the capital gains distribution owns 5% or less of the distributing REIT. Thus, foreign investors receiving such capital gains distributions would not have to file a U.S. tax return or pay the "branch profits" tax merely because they receive such dividends. The REIT making these distributions would withhold U.S. taxes at a 30% rate (instead of the 35% rate required on capital gains distributions under current law), unless the shareholder is a resident of a country with a bilateral tax treaty that prescribes a lower rate. For a detailed chart summarizing these tax rates, click HERE. These provisions would be effective for taxable years beginning after date of enactment.

Clarification That Timber Sales Can Qualify for Safe Harbor from 100% Tax

Current law imposes a 100% tax on a REIT's 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, a safe harbor from this tax can apply to property held for at least 4 years for the "production of rental income."

Current law 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. Nevertheless, timber REITs face the same prohibited transaction rules, 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. S. 1637 includes a provision that would broaden the safe harbor so that is 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. This provision would apply to taxable years beginning after date of enactment.

Outlook

Following a decision by the World Trade Organization (WTO) that the FSC/ETI provisions of the U.S. tax code were illegal, the European Union has imposed a 6% penalty payment on some U.S. exports, set to increase by 1 percentage point a month, up to a maximum of 17%. If the FSC/ETI bill becomes law, this penalty would be removed.

Although both Republicans and Democrats view legislation that would repeal the FSC/ETI system as necessary legislation this year, it is still not clear whether this legislation will be enacted. Reportedly, policymakers have not heard extensive complaints from the business community regarding the sanctions, and the

absence of such complaints reduces the pressure to enact this legislation. Further, the fact that 2004 is an election year makes bipartisan agreement on any legislation difficult.

Now that the Senate has passed its version of the international tax bill, there may be a greater impetus for the House to act on its version of the FSC/ETI Bill, H.R. 2896, which contains Title I of the RIA (other than the timber/dealer sales provision included in S. 1637).

Once the House passes its own version of this legislation, the House and Senate bills would go to a conference committee with the objective to create a compromise bill for the President to sign into law. If the FSC/ETI bills go to conference, NAREIT will work with the conference committee to incorporate all three titles of the RIA into the final bill.

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

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