December 22, 2005

national policy
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National Association of Real Estate Investment Trusts®

FAVORABLE TECHNICAL CORRECTIONS TO THE REIT IMPROVEMENT ACT ARE ENACTED

EXECUTIVE SUMMARY

Yesterday, President Bush signed H.R. 4440, the Gulf Opportunity Zone Act of 2005 (the Act). The Act provides substantial tax relief to taxpayers located in areas adversely impacted by the recent hurricanes and also includes a number of technical corrections to previous tax legislation, including the REIT Improvement Act (RIA) provisions that were included in the American Jobs Creation Act of 2004 (Jobs Act). The Joint Committee on Taxation description of the Act can be found at this link.

The Act expands the technical corrections applicable to REITs that were contained in the Tax Technical Corrections Act of 2005, H.R. 3376 (TTCA), which was introduced earlier this year. The amendments made by the technical corrections part of the Act will take effect as if included in the Jobs Act.

DISCUSSION

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, 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 the new law. Accordingly, following the passage of the Jobs Act on Oct. 22, 2004, NAREIT began a dialogue with policy-makers to seek the enactment of certain technical changes to prevent such disqualification and/or additional expense.

On Jan. 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 Act (see H.R. 4440 at pages 44-47, 50-51 and 63) favorably addresses all of the RIA issues NAREIT raised with policy-makers.

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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 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 supported 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.

Transition Rule - The TTCA evidenced 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 would have clarified that securities of a partnership that are held by a REIT on or after Oct. 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, would 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.

A significant potential issue regarding this change was that the TTCA required that the securities have been held by the REIT on Oct. 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 appeared that it could have been 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 Oct. 22, 2004, **but which disposed of the non-qualifying securities** to have faced retroactive disqualification.

We are pleased to report that the Act adopts NAREIT's recommendation to change the transition rule by deleting the requirement to hold the partnership interest after the Job Act's effective date. The Joint Committee explanation makes clear on page 80 that the transition rule applies "regardless of whether [the securities of a partnership] were disposed of before the date of enactment or whether the REIT has disposed of its interest in the partnership equity to the 1%-or-less interest required by the [Jobs] Act."

<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 Oct. 22, 2004, the regulations under section 1221 require 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 Oct. 22, 2004.

Act Change - Consistent with the TTCA, the Act clarifies 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 Act" (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 by treating 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. See link for applicable withholding rates depending on the residence of the REIT foreign investor. The change applied to "taxable years beginning after Oct. 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 Oct. 22, 2004 (thus, generally to distributions made after Jan. 1, 2005) or to the shareholder's taxable year beginning after Oct. 22, 2004 (thus, potentially to distributions made to shareholders any time after Oct. 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 have been 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.

Act Changes - Consistent with the TTCA, the Act 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 Act clarifies that the FIRPTA change generally 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 had 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 was theoretically possible that a REIT could make a deficiency dividend including capital gain distributions made after Oct. 22, 2004, that relates to a taxable year that began prior to Oct. 22, 2004.

We are pleased to report that the Act adopts NAREIT's recommendation that the exclusion from FIRPTA apply to deficiency dividends that are paid after the date of enactment but that are treated as deductible in taxable years beginning on or after the date of enactment.

<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 (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 if 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 have been interpreted to mean that there were no "cure" provisions in the Act for *de minimis* violations of the 20%, 25%, or 75% asset tests. Under this interpretation, 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 have faced REIT disqualification.

Jobs Act Clarification - Consistent with the TTCA, the Act 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).

<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 have been interpreted to mean that the REIT Savings provisions would not apply if in a year after 2004, a REIT found a problem with respect to any of the REIT requirements relating to 2004 or earlier. 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.

Act Clarification - Consistent with the TTCA, the Act amends 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 Oct. 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 favorably responds to NAREIT's requested clarification.

<u>Clarification Regarding Effective Date of Deficiency Dividend Provisions</u>

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 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 that any technical corrections legislation clarify that the provision applied to determinations made after Oct. 22, 2004.

Act Clarification - Consistent with the TTCA, the Act provides that this provision applies to failures with respect to which the Jobs Act requirements are satisfied after the Jobs Act's date of enactment. Consistent with NAREIT's request, the Joint Committee explanation specifies on page 80 that the new deficiency dividend rules apply to **statements filed** with the IRS in taxable years beginning after Oct. 22, 2004.

Clarification Regarding Timberland Safe Harbor

Prior law - Since 1976, the tax code has provided a safe harbor from the prohibited transaction tax for sales of rental property if certain requirements are met (the Rental Safe Harbor). The tax code specifies that the Rental Safe Harbor is merely a safe harbor and that a REIT that fails to meet the safe harbor still can avoid the 100 % tax by applying a facts and circumstances test as though the Rental Safe Harbor and the attendant rules of application had not been enacted.

Jobs Act Change - The Jobs Act established a new safe harbor for sales of timberland from the 100% prohibited transactions tax for gains attributable to the sale of "dealer property" (the Timber Safe Harbor). However, the Jobs Act did not cross reference the Code subsection specifying that a facts and circumstances test may be used in the event that the safe harbor requirements are not satisfied.

As a result, one could have made the negative inference that a REIT, which under prior law could avoid the 100% prohibited transaction tax if its sold rental property was not "dealer property" after application of a facts and circumstances analysis, could not use a facts and circumstances test for the sale of timberland if it failed to meet the Timber Safe Harbor.

Act Clarification - Although this issue was not addressed by the TTCA, we are pleased to report that the Act includes the cross-references that NAREIT requested (see section 412(ii) of the Act on page 63 of H.R. 4440) so as to clarify that a facts and circumstances test applies even if the Timber Safe Harbor is not satisfied. The Act also provides that certain other provisions used in applying the Rental Safe Harbor, such as multiple sales to one party counting as a single sale, also apply to the Timber Safe Harbor.

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