REITS IMPROVED

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I. INTRODUCTION

On October 22, 2004, President Bush signed the export tax reform bill entitled the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (the Act), that contains all three titles of the NAREIT-supported REIT Improvement Act (RIA),[1] as well as a provision that reduces the recovery period for certain leasehold improvements from 39 to 15 years for second-generation tenant improvements placed in service through 2005. Although the separate House-passed (H.R. 4520) and Senate-passed (S. 1637) versions of the Act together contained the three titles of the RIA, each bill contained separate titles of the RIA. Similarly, the leasehold improvement provision was contained only in the prior House-passed version of the export tax bill.

II. EXECUTIVE SUMMARY

The provisions in the Act affecting real estate investment trusts (REITs) are comprehensive and significant. The Act should allow a REIT to operate its real estate business more efficiently for the benefit of its shareholders.

The Act adopted all three titles of the RIA, which are described in more detail below. First, Title I of the RIA includes a number of provisions, including one that allows a REIT to make certain loans in the ordinary course of business without the risk of losing REIT status and another that permits timber sales to qualify for a new safe harbor from the 100% prohibited transactions tax. Second, Title II of the RIA substantially conforms the treatment of foreign shareholders in publicly traded REITs to that of foreign shareholders in other publicly traded U.S. companies. Finally, Title III of the RIA allows REITs to avoid REIT disqualification for non-intentional REIT test violations either by, among other things, 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.

The Act contains a number of other provisions that apply to REITs such as the reduction in the recovery period from 39 to 15 years for second-generation tenant improvements placed in service through 2005. Second, the Act extends the status of domestically-controlled REITs to

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[1] The actual RIA bill in the House was H.R. 1890, which was introduced on April 30, 2003, and ultimately co-sponsored by over three-fourths of the House Ways and Means Committee. The lead co-sponsors were Representatives Jim McCrery (R-LA) and Ben Cardin (D-MD). In the Senate, the actual RIA bill was S. 1568, which was introduced on August 1, 2003, and ultimately co-sponsored by over one-half of the Senate Finance Committee. The lead co-sponsors were Senators Orrin Hatch (R-UT) and John Breaux (D-LA). In introducing the RIA, Senator Hatch stated that it would make "a number of minor but important changes to remove uncertainties in the law and improve [the] investment climate [related to REITs] . . . The [RIA] is the product of almost two years of discussions with the staffs of the Treasury Department and the Joint Committee on Taxation on how to find solutions to several thorny problem areas where the rules are in need of clarification or modification. . . . Although these provisions have very little effect on revenue to the Treasury, they are of considerable importance to REITs because they remove uncertainties that interfere with the efficient operation of their businesses." 149 Cong. Rec. S10917 (Daily Ed. August 1, 2003) *(remarks of Senator Hatch).*

include mutual funds. Third, the Act provides a deduction from taxable income for certain construction activities performed in the United States.

III. REIT PROVISIONS

A. Expansion of Straight Debt Safe Harbor

One of the major changes of the Act involves a change to the REIT asset tests. As further described below, these retroactive changes better allow REITs to make certain loans in the ordinary course of business without risking the loss of a company's REIT status.

1. The REIT Asset Test Prior to the REIT Modernization Act of 1999

By way of background, the activities of REITs are limited by a number of requirements that are designed to ensure that REITs serve as a vehicle for investment in real estate available to a large group of shareholders. For example, a REIT must satisfy several asset tests.[2] On the last day of each quarter, at least 75% of a REIT's assets must be real estate assets, cash or government securities.[3]

Furthermore, the asset diversification rules for years have required that a REIT not own more than 10% of the outstanding voting securities of an issuer (other than another REIT or a qualified REIT subsidiary under section 856(i)) (the "10% voting limitation").[4] In addition, no more than 5% of a REIT's assets can be represented by securities of a single issuer (other than another REIT or a qualified REIT subsidiary) (the "5% value limitation").[5]

Until the passage of the Act, a REIT's failure to comply with the asset tests resulted in disqualification, as there was no ability to "cure" an asset test failure, unless the REIT reached an accommodation with the IRS through a closing agreement or a private letter ruling.[6] Once REIT status is terminated, an entity cannot re-elect REIT status until the fifth taxable year that begins after the first taxable year for which such termination is effective, unless it secures the consent of the IRS.[7]

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[2] § 856(c)(4) of the Internal Revenue Code of 1986, as amended (the Code). Unless otherwise noted, all references to a section in this article are to a section of the Code.
[3] § 856(c)(4)(A).
[4] § 856(c)(4)(B)(iii)(II).
[5] § 856(c)(4)(B)(iii)(I).
[6] In 2004, the IRS issued over ten private letter rulings allowing REITs additional time to elect to treat a company as a taxable REIT subsidiary in order to avoid an asset test violation. *See* PLRs 200451028, 200450013, 200442018, 200440018, 200433008, 200433005, 200433003, 200429002, 200428006, 200422021, 200419010 and 200403005.
[7] § 856(g)(3).

2. The REIT Modernization Act of 1999 Added a 10% Value Rule

In 1999, Congress passed the REIT Modernization Act (RMA)[8] to update the asset test to permit REITs to own taxable REIT subsidiaries (TRSs) that can engage in business operations not permitted to REITs. In exchange for permitting this new TRS arrangement, the RMA added an additional rule to the prior REIT asset tests: it prohibited REITs from owning more than 10% of the value of any other entity's securities other than securities in a TRS or in another REIT (the 10% value rule).[9] The RMA went into effect for taxable years beginning after 2000.

Of significant importance in complying with the asset test is that, for purposes of the REIT rules, terms not defined within § 856 (such as "securities") have the same meaning as when used in the Investment Company Act of 1940, as amended (the 40 Act).[10] The 40 Act defines a "security" to include any note, stock, treasury stock, bond, debenture or evidence of indebtedness. An issuer is defined as any natural person or company who issues or proposes to issue any security, or has outstanding any security which it has issued. Accordingly, virtually any type of debt instrument, other than a mortgage,[11] issued by virtually any type of issuer (including a human being), may constitute a "security" for purposes of the REIT asset tests.

Although the 10% value rule was intended to prevent REITs from owning more than 10% of the equity of another corporation, because of the 40 Act's inclusion of most debt instruments in the definition of "securities", the rule potentially applied to many situations when individuals and businesses owe some sort of debt ("security" defined broadly) to a REIT. To address these types of non-abusive transactions, the RMA provided a safe harbor for "straight debt" securities that incorporated a rule used for S corporations in determining whether the S corporation has a prohibited second class of stock.

a. The "Straight Debt" Safe Harbor Under the RMA

Specifically, § 856(c)(7) (prior to amendment by the Act) provided that securities of an issuer that satisfied the definition of "straight debt" in § 1361(c)(5) (without regard to subparagraph (B)(iii) thereof) would not be taken into account in applying the 10% value test if: (A) the issuer were an individual; (B) the only securities of the issuer which were held by the REIT or a TRS of the REIT were straight debt (as so defined); or, (C) the issuer were a partnership and the REIT held at least a 20% profits interest in the partnership.[12]

As applicable to § 856(c)(7), § 1361(c)(5) provides that "straight debt" means any written unconditional promise to pay on demand or on a specified date a sum certain in money if: (i) the

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[8] Sections 541-571 of Pub. L. No. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999.
[9] § 856(c)(4)(B)(iii)(III). The stock of a qualified REIT subsidiary under § 856(i) is not considered a security for this purpose.
[10] § 856(c)(5)(F).
[11] Treas. Reg. § 1.856-3(e) ("The term "securities" does not include interests in real property" or "real estate assets" as those terms are defined in section 856 and [herein].")
[12] The relevant Conference Report stated that the purpose of this 20% rule "is to assure that if the partnership produces income that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly through its partnership interest, even though it also may derive qualified interest income through its safe harbor debt interest." H.R. Rep. No. 478, 106th Cong., 1st Sess. 177 (1999).

interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion or similar factors; and, (ii) there is no convertibility (directly or indirectly) into stock. Treas. Reg. § 1.1361-1(l)(5)(A) adds the additional factor that straight debt does not include debt on which the interest is contingent on the payment of dividends with respect to common stock. There is little guidance on the interpretation of this provision under the S corporation rules. Unlike the straight debt safe harbor in the S corporation area, if securities owned by a REIT failed to qualify as straight debt and failed to satisfy the 10% value limitation, they would have automatically caused the REIT to lose its REIT status.

b. Examples of Ordinary Business Loans That Could Not Qualify for the "Straight Debt" Safe Harbor Under the RMA

Following the effective date of the RMA, NAREIT became aware of several non-abusive and ordinary business loans that could have led a REIT inadvertently to have lost its REIT status even though the specific loan transaction in no way related to the apparent policy reason behind the enactment of the 10% value limitation – to prevent a REIT from acquiring significant economic ownership in an entity through stock in order to transmute non-real estate income into operating income not subject to corporate-level tax. In many cases, such inadvertent de-REITing could have occurred because of the interplay of the expansive definition of "securities" under the 40 Act and the very narrow definition of "straight debt" under the S corporation safe harbor.

Set forth below are examples that illustrate the problems with the straight debt provisions of section 856(c)(7) under prior law.

i. Loans to Individuals

A. Loans to Employees to Acquire REIT Stock

In order to further align the interest of its employees with that of its shareholders, it was not uncommon for a REIT to extend loans to employees in order to purchase REIT stock. The interest payment on such loans sometimes was limited to the dividends paid on the REIT stock, although all accrued but unpaid interest was due on a set maturity date.

Because the interest payments would depend on a dividend on common stock, this loan could not qualify as straight debt, even though the total interest due on the loan was payable on a set maturity date. If the individual's promissory note was a "security", it was possible that the REIT's loan to the individual may have been worth more than 10% of the individual's total outstanding "securities," particularly if the individual had no other significant assets or debts.

B. Loans to Individual Tenants Contingent on Cash Flow and Representing More than 10% of Issuer's Outstanding Securities

It is not unusual for a REIT to advance funds to a small business tenant or franchisee for the acquisition of leasehold improvements or equipment. The REIT's loan could represent more than 10% of the outstanding securities, in which case loss of REIT status could have occurred even for a very small loan if, as is sometimes the case for small tenants, the repayment timing was contingent on the tenant's cash flow (although all payments were due at the loan's maturity).

ii. Rent Holidays and Stepped Rents Under Section 467

Under § 467, a lease provision that includes stepped rents could be viewed as creating a loan for income tax purposes from the REIT to the tenant. If this loan were a "security" under the 40 Act, it would not qualify under the straight debt exception if the REIT owned other securities of the tenant. Depending on the size of this loan as compared to the tenant's outstanding securities, the REIT could fail the 10% value rule.

iii. Back Rents

Similar to rent holidays, a REIT and a tenant could agree that the tenant owes back rents. This situation could occur if the tenant is experiencing financial difficulties, either within or without the context of a formal bankruptcy proceeding. Under the 40 Act's expansive definition of security, the tenant's obligation for back rents could be viewed as a security. If the timing for repayment were dependent upon the tenant's profits or cash flow (or bankruptcy court approval), the security would not be considered straight debt.

iv. Loans Resulting from Tax-Increment Financing

In order to encourage a real estate company to develop or purchase a property in a particular location, a local municipality sometimes will issue to the public tax increment bonds under which a private developer has the right to a rebate of a portion of the sales taxes generated by a property being developed in a tax increment district (which often is blighted or otherwise needs government assistance to spur private development). The municipality's obligation is often evidenced by a promissory note, unquestionably a security under the 40 Act.

Because the timing of the payment of the municipality's debt was contingent on sales or other taxes being collected in the tax increment district, such financing would not satisfy the requirements for straight debt. This type of financing transaction is often a key factor in a real estate company's decision to develop a property in a particular locality, and the straight debt rule's *de facto* prohibition of this type of attractive financing made REITs non-competitive.

3. The Act's Change to the Straight Debt Safe Harbor

In general, the greatest problem with the prior law safe harbor occurred with ordinary business loans if the time of repayment on the loans was subject to a contingency, such as an acceleration in the maturity date of a loan due to an increase in a tenant's cash flow. To address this issue, the Act modifies and expands the prior law safe harbor to, among other things, allow otherwise qualifying "straight debt" under the S corporation definition to continue to qualify as straight debt even if the time or amount of payment is subject to a contingency, so long as certain conditions are met.[13] The Conference Report to the Act notes that this was done "to provide more flexibility than the [prior] law rule."[14] Because these changes are retroactive to the effective date of the RMA, they greatly assist REITs that had made loans in the ordinary course of business following the RMA, only to find their REIT status potentially jeopardized as a result. For purposes of this article, loans that satisfy the expanded and modified safe harbor in new § 856(m) are referred to as "safe harbor securities."

Further, the Act deletes the requirement under prior law that a REIT (or its TRS) either own no securities in an issuer or, in the case of a partnership, that a REIT own at least a 20% profits interest in the partnership.[15] The Act instead provides new "look-through" rules determining a REIT partner's share of partnership securities, generally treating non-mortgage debt to the REIT as part of the REIT's partnership interest for this purpose, except in the case of otherwise qualifying debt of the partnership.[16] The Act also does away with prior law's requirement that a REIT or its TRS own no securities in an issuer other than "straight debt" by including a *de minimis* rule that permits a REIT and/or a TRS in which it owns over 50% to own non safe harbor securities worth not more than 1% of the value of an issuer's outstanding securities.[17]

The Act also creates special rules applicable to loans by REITs to partnerships and to the calculation of securities owned by REITs through partnerships. Specifically, loans that would not otherwise qualify under the safe harbor to partnerships whose income is primarily from real estate sources ("Real Estate Partnerships") are *per se* excluded from being "securities" for purposes of the 10% value rule. Furthermore, any loan by a REIT to a partnership in which the REIT is a partner is not considered a security to the extent of the REIT's interest as a partner in the partnership.

The Act also: i) lists certain types of loans, such as loans to individuals or other REITs, that *per se* are not considered "securities" for purposes of the 10% value rule; and ii) grants regulatory authority for the IRS to exclude additional types of loans from being treated as "securities" for purposes of this rule.

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[13] After NAREIT became aware of the potential difficulties concerning the straight debt safe harbor, it suggested a simple remedy that would define "straight debt" as all debt other than debt based on net profits or debt that was convertible into stock. However, policymakers decided that such a definition would be too broad.

[14] H.R. Rep. No. 755, 108th Cong., 2d Sess. 319 (2004).

[15] The legislative history to the RMA suggested that a REIT that made a loan to a partnership was required to own at least a 20% profits interest in the partnership, H.R. Rep. No. 478, 106th Cong., 1st Sess. 177 (1999), while the statute clearly stated that a REIT either could own straight debt in a partnership in which neither it nor its TRSs owned <u>any</u> non-straight debt securities or, if the REIT owned an interest in the partnership, it had to own at least a 20% profits interest. § 856(c)(7), as in effect before the Act.

[16] H.R. Rep. No. 755, 108th Cong., 2d Sess. 319-20 (2004)

[17] § 856(m)(2)(C).

a. Expansion of Definition of "Straight Debt" To Include Certain Contingencies Relating to Timing or Amount of Payment

Although the Act again defines "straight debt" by reference to § 1361(c)(5) (without regard to subparagraph (B)(iii) (regarding the nature of the creditor), the Act allows loans to qualify as straight debt if the time of payment, in certain cases, or the time or amount of payment, in other cases, is subject to certain contingencies. To prevent a REIT from becoming too involved in the business of a borrower, there are the following limits on the types of permitted contingencies.

First, a security may satisfy the definition of "straight debt" even though the time of payment of interest or principal thereunder is subject to a contingency if: (i) such contingency does not have the effect of changing the effective yield to maturity more than the greater of .25% or 5% of the annual yield to maturity; or, (ii) neither the aggregate issue price nor the aggregate face amount of the issuer's debt instruments held by the REIT exceeds $1 million and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.[18]

Second, a security may satisfy the definition of "straight debt" even though the time or amount of any payment thereunder may be subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, provided that such contingency is consistent with customary business practice.[19]

These changes apply to taxable years beginning after December 31, 2000, the effective date of the RMA. Thus, they permit a REIT that had made such loans in the past to avoid risking REIT status merely as a result of a loan that, for example, required the payment of prepayment fees.

b. *Per Se* Inclusion of Certain Debt Instruments as Safe Harbor Securities

In addition to debt instruments that meet the expanded definition of "straight debt" described above, as a simplification measure the Act explicitly enumerates the following types of ordinary, non-abusive loans as safe harbor securities and excludes them from the definition of "securities" for purposes of the 10% value rule:

(A) any loan to an individual or estate;
(B) any "section 467 rental agreement," other than with a related person described in § 856(d)(2)(B);
(C) any obligation to pay "rents from real property";
(D) any security issued by a state or any political subdivision thereof, the District of Columbia, a foreign government or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment under such security does not depend on the profits of any entity not described in § 856(m)(1)(A)-(G) or payments on any obligation issued by such an entity;
(E) any security issued by a REIT; or

[18] § 856(m)(2)(B).
[19] *Id.*

(F) any other arrangement as determined by the Secretary of the Treasury.[20]

c. Rules Related to Partnerships

The Act deletes the requirement that a REIT own a 20% profits interest in a partnership when it owns non- straight debt securities in a partnership, but it replaces this requirement with new *de minimis* and look-through rules as well as a few other rules that apply to loans to partnerships.[21]

i. *De Minimis* Rule

The Act adds a *de minimis* rule that allows a REIT to make a straight debt loan to a partnership in which it (and/or any TRS in which it owns a controlling interest by vote or value) owns non safe harbor securities with a value of not more than 1% of the partnership's outstanding securities.[22] This provision is retroactive, applying to taxable years beginning after December 31, 2000.

Among other things, the provision states that, if a REIT owns both: (i) otherwise qualifying safe harbor securities in a partnership; and, (ii) securities in such partnership that are not safe harbor securities and whose value exceeds more than 1% of such partnership's outstanding securities, then the otherwise qualifying safe harbor securities will be disqualified from being considered safe harbor securities. In this case, if the aggregate value of the total debt securities issued to the REIT by the partnership exceeds 10% of the partnership's outstanding securities, the REIT could lose REIT status. Moreover, such loss of REIT status could be retroactive to taxable years as far back as 2001.

The retroactivity of this provision raises a number of issues for REITs that made qualifying "straight debt" loans by relying on the different requirements of prior law. Specifically, a REIT that owned the following securities in a partnership prior to the effective date of the Act would not have failed the 10% value test due to the ownership of these securities under prior law but would appear to fail the 10% value test retroactively after the Act: (i) at least a 20% profits interest in the partnership; (ii) "straight debt" securities under § 856(c)(7) (and under § 856(m)(1) prior to the application of § 856(m)(2)(C)) with an aggregate value in excess of 10% of the partnership's outstanding securities; and (iii) non-"straight debt" securities with an aggregate value greater than 1%, but less than 10%, of the partnership's outstanding securities. This result seems overly harsh for a REIT that had no recourse but to rely on the plain language of prior law and can take no current action to improve its situation.[23]

NAREIT is pursuing a clarification to this provision in a technical corrections bill that either would treat securities held by a REIT or a successor in a carryover basis transaction that

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[20] § 856(m)(1)(B)-(G). The last exclusion allows REITs to obtain certainty with respect to a particular proposed arrangement by obtaining a private letter ruling from the IRS. It also provides the IRS and Treasury Department significant discretion in issuing public guidance on what constitutes safe harbor securities.
[21] H.R. Rep. No. 755, 108th Cong., 2d Sess. 319-20 (2004).
[22] § 856(m)(2)(C).
[23] The "REIT Savings" provisions of the Act, permitting a REIT to "cure" a REIT test violation in lieu of REIT disqualification, are prospective only.

qualified as "straight debt" under prior law as continuing to qualify, or, alternatively, would apply § 856(m)(2)(C) prospectively.

ii. Look-Through Rules

The Act contains new look-through rules in § 856(m)(3), which is entitled "Look-Through Rule for Partnership Securities." The first part of § 856(m)(3), § 856(m)(3)(A)(i), actually is not a look-through rule but merely codifies prior practice. It provides that for purposes of the 10% value rule, "a [REIT's] interest as a partner in a partnership . . .shall not be considered a security."(emphasis added). § 856(m)(3)(A)(ii) then provides that "the REIT is deemed to own its proportionate interest of each of the assets of the partnership." (emphasis added). Finally, § 856(m)(3)(B) provides the actual "look-through" rules.

Unlike the other provisions in the new safe harbor which are retroactive to the effective date of the RMA, § 856(m)(3)(B) is prospective only. It states that "the [REIT's] interest in the partnership assets shall be the [REIT's] proportionate interest in any securities issued by the partnership [including, among other things, the REIT's equity interest in the partnership, but not including safe harbor securities]."(emphasis added).[24] Thus, the look-through rule requires a REIT that is a partner in a partnership to look through not only its equity interest in the partnership, but also its interest in the non safe harbor debt securities issued by the partnership. Furthermore, the statute appears to require a REIT to make this determination by comparing the relative fair market values of partnership assets.[25]

Arguably, the look-through rule in § 856(m)(3)(B)(i) could be read to treat a REIT that owns non-safe harbor debt in a partnership, but no equity interest in the partnership, as owning an interest in the partnership's underlying assets. The better reading of § 856(m)(3) is that the look-through rule only applies to a REIT that is an actual partner in the partnership. § 856(m)(3)(A) uses the indefinite article as the starting point "a [REIT] that is a partner in a partnership". The remaining sections of § 856(m)(3) use the definite article, "the" to refer to the REIT that is determining its proportionate interest in the partnership.

Thus, the implication is that, for § 856(m)(3) to apply to a REIT, the REIT first must be a partner in the partnership. The Conference Report to the Act agrees with this reading by stating that the Act "provides new look-through" rules determining a REIT partner's share of partnership securities, generally treating debt to the REIT as part of the REIT's partnership interest for this purpose, except in the case of otherwise qualifying debt of the partnership."[26] (emphasis added).

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[24] § 856(m)(3)(B)(i). Because these new provisions apply only to REITs, it would appear that partnership interests held by non-REITs would be considered as part of the partnership's outstanding securities in applying this test. Cf. Treas. Reg. § 1.856-3(g).

[25] This new look-through rule thus differs from Treas. Reg. § 1.856-3(g), which applied pre-Act to determine a REIT's proportionate share of a partnership's assets in accordance with its capital interest in the partnership for purposes of the REIT asset and gross income tests. The new look-through rule in § 856(m)(3)(B) applies only for purposes of the 10% value rule for taxable years beginning after October 22, 2004. Treas. Reg. § 1.856-3(g) continues to apply for purposes of the other REIT asset and gross income tests.

[26] H.R. Rep. No. 755, 108th Cong., 2nd Sess. 319-20 (2004).

iii. Other Rules Relating to Loans to Partnerships

The Act excludes the following two types of loans by REITs to partnerships from being treated as "securities" for purposes of the 10% value rule. First, any non-safe harbor debt instrument issued by a partnership will not be considered a "security" to the extent of the REIT's interest in the partnership. Second, any non-safe harbor debt instrument issued by a partnership will not be considered a "security" if at least 75% of the partnership's gross income (excluding gross income from prohibited transactions) is derived from the sources described in § 856(c)(3) (essentially real estate-related income) (such partnership, a "Real Estate Partnership, and such rule, the "Real Estate Partnership Rule").[27] The second exception should exempt as securities loans to UPREITs, downREITs, and most typical real estate joint ventures, such as those with pension plans. However, the Real Estate Partnership Rule would appear not to apply to a REIT's loan to a development partnership that has not yet leased a building it is constructing because the partnership does not yet generate qualifying income.

Both exclusions also are retroactive to the effective date of the RMA.[28] They do not apply when a REIT is calculating its proportionate interest in partnership securities.[29] Because these rules are retroactive, they should be particularly helpful to REITs with loans to Real Estate Partnerships that are possibly non-qualifying due to timing issues.

B. Expansion of Limited Rental Exception

The RMA contained several rules to prevent a REIT from inappropriately shifting income out of its TRS to the REIT (which is subject to only one level of tax).[30] For example, rent paid by a TRS to its controlling REIT qualifies as rental income under the REIT tax tests only if at least 90% of the space is rented by unrelated parties (the 90% rental threshold), and the TRS pays rent comparable to that paid by the unrelated parties.[31]

Application of the limited rental exception was unclear because prior law did not contain a measurement date for determining how much of the REIT's property was rented by unrelated parties or at comparable rates, nor did it address the consequences of lease terminations that have the effect of increasing the percentage of property rented to the subsidiary above 90%. For example, an anchor tenant that owned over 90% of the space in a shopping mall might cancel its lease for any one of a number of reasons outside the REIT's control (*e.g.*, financial problems), thereby potentially converting qualifying income from a pre-existing lease between the REIT and its TRS into non-qualifying income.

The Act clarifies these rules by testing the comparability of rents: (i) at the beginning of a lease term; (ii) upon a lease extension; and, (iii) upon a lease renegotiation when the rent between a REIT and its subsidiary is increased.[32] So long as the 90% rental threshold is met at the three

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[27] § 856(m)(4)(A) and (B).
[28] § 243(g) of the Act.
[29] § 856(m)(3)(B)(i).
[30] § 857(b)(7).
[31] § 856(d)(8)(A).
[32] § 856(d)(8)(A)(iii)(I)-(III), as added by the Act.

times described above, the test will continue to be met when the actual amount of space rented to a TRS does not increase.[33] If the REIT owns more than 50% of the vote or value of a TRS, and the rent payable by such TRS is increased pursuant to the third situation, then the increase in rent will not be treated as qualifying rent.[34] This provision also is effective for taxable years beginning after December 31, 2000.[35]

C. Deletion of Customary Services Exception to 100% Tax on Redetermined Rents and Deductions

Current law imposes a 100% excise tax on income or deductions improperly shifted between a REIT and one of its TRSs.[36] This excise tax was meant to exempt from this tax income the subsidiary earns that is attributable to services the REIT could provide while generating qualifying income. However, the safe harbor was improperly drafted so that it did not carry out its original intent and could not be fully applied as written. [37]

The Act simplifies current law by deleting this ambiguous safe harbor while leaving another safe harbor available. Specifically, such payments are free of the excise tax if the REIT pays the TRS at least 150% of the TRS' cost in providing the service.[38]

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[33] § 856(d)(8)(A)(v). This provision is particularly helpful in the event that an anchor tenant terminates a lease, thereby causing the percentage of a REIT's property rented to a TRS to increase above 10%. So long as the TRS does not increase the actual space rented from the REIT, the rent from the TRS will continue to be qualifying rent. Even if the TRS does increase the amount of space rented from the REIT during a particular calendar quarter, the 90% rental threshold will be considered to have been met during such quarter and the succeeding quarter if the 90% rental threshold is met at the end of the succeeding quarter. Essentially, the REIT has one quarter to satisfy the 90% rental threshold in this situation.

[34] § 856(d)(8)(A)(iii) (flush language).

[35] § 243(g) of the Act.

[36] § 857(d)(7).

[37] § § 857(b)(7)(B)(ii), prior to deletion by the Act. The statutory language stated that the 100% penalty would not apply to "amounts received directly or indirectly by a [REIT]-- (I) for services furnished or rendered by a [TRS for services] that are described in [§ 856(d)(1)(B) ([customarily furnished with the rental of real property)], or (II) **from** a [taxable REIT subsidiary] that are described in [§ 856(d)(7)(C)(ii) (services that can be rendered by a tax-exempt organization without giving rise to unrelated business taxable income)]." (emphasis added). The second part of this provision was ambiguous because it appeared to say that payments **from** a TRS to a REIT for services that could be provided by a tax-exempt organization without giving rise to UBTI would be exempt from the 100% penalty although it was unlikely that a TRS would be paying a REIT these amounts. It would be more likely that a TRS might be providing these services, but the tenant's rent paid to the REIT would be higher to reflect the value of these services. Thus, the statute would have been clearer if it had said that the 100% penalty did not apply to payments **from a tenant** to a REIT for the provision of these services.

[38] § 857(b)(7)(B)(vi). *See generally* Rev. Rul. 2002-38, 2002-26 I.R.B. 4. (when REIT pays TRS less than 150% of its direct cost of providing noncustomary services, and that payment is less than the arm's length charge for such service, no safe harbor protects REIT from imposition of the 100% tax on redetermined rents).

D. Conformity with General Hedging Definition

Since 1997, the REIT rules have provided that any amounts a REIT realizes from any hedge of real estate debt "to reduce interest rate risks" qualifies as good REIT income for purposes of the 95% gross income test.[39] Legislative history indicates that those rules apply to foreign currency hedging of a REIT's debt.[40]

The Act conforms the definition of a hedge to the general Code provision in section 1221, and disregards any such hedge income in computing the 95% test. This new test modifies the REIT hedging rule to make clear that hedges include a variety of circumstances, *e.g.*, a currency hedge of mortgage debt. Specifically, revised § 856(c)(5)(G) provides that "except to the extent provided by regulations, any income of a [REIT] from a hedging transaction (as defined in clause (ii) or (iii) of section 1221(b)(2)(A)) which is clearly identified pursuant to section 1221(a)(7) . . . shall not constitute gross income under [the 95% gross income test] to the extent that the transaction hedges any indebtedness incurred or to be incurred by the [REIT] to acquire or carry real estate assets." This provision is effective for taxable years beginning after October 22, 2004.

There are two important consequences of this law change. First, because it disregards for purposes of the gross income test income from properly identified hedging transactions, the provision reduces a REIT's 5% nonqualifying income basket. Under prior law, income from qualified hedging transactions was counted as "good" income under the 95% income test, and therefore increased the denominator used to calculate a REIT's nonqualifying income as a percentage of total income. Beginning in taxable years after date of enactment, this type of income is longer included in the denominator of this fraction, thereby potentially decreasing the amount comprising a REIT's "5% basket" of allowed nonqualifying income.

The second consequence relates to hedges that are not properly identified under § 1221(a)(7). Section 1221(a)(7) requires identification of a hedging transaction as such before the close of the day on which it was acquired, originated, or entered into (or such other time as designated under regulations). REITs may not have identified their hedges within this time period as identification was not required previously for REIT qualification purposes. As a result, these hedges now may generate non-qualifying income.

The regulations under § 1221(a)(7) contain some relief for failure to identify due to inadvertent error, but the relief appears to relate to treating the income from the hedging transaction as ordinary income or loss, rather than treating the hedging transaction as "properly identified." Going forward, REITs need to be certain that they properly identify hedges under § 1221(a)(7) and the regulations thereunder. NAREIT is pursuing a clarification in technical corrections

[39] § 856(c)(5)(G). Prior to 1997, the REIT hedging rule only applied to a hedge of a variable rate debt.
[40] At the time of introduction of the REIT Simplification Act of 1997, Congressman Clay Shaw (R-FL) stated "[T]his provision would apply to hedging a REIT's unsecured corporate debenture or the currency risk of a debt offering denominated in a foreign currency." 143 Cong. Rec. E559 (Daily Ed. March 21, 1997).

legislation that would apply the new provisions only to transactions entered into in taxable years beginning after October 22, 2004.[41]

E. Conformity to Mutual Fund Rules Regarding Failure to Meet Source of Income Tests

Each year, at least 75% of a REIT's gross income must be from real estate related sources, and at least 95% of its gross income must be from a combination of real estate and passive income sources.[42] REITs failing to satisfy the tests can be considered have met them if the failure was due to reasonable cause.[43] REITs that fail these tests are subject to additional taxes based on the difference between their actual income and the income required to have met these tests.[44]

In 1999, Congress inadvertently forgave from this tax REITs whose income from real estate and passive sources was more than 90% but less than 95% of total gross income. The Act corrects that mistake for taxable years beginning after October 22, 2004, by applying a taxable fraction based upon 95%, rather than 90% of the REIT's gross income.[45]

F. REIT Savings

There are certain so-called "death trap" provisions in the REIT rules, a violation of which can result in the disqualification of the REIT. Naturally, REIT managers expend significant resources to avoid such a drastic result.

The Act builds in some flexibility to the REIT tax rules and imposes at most monetary penalties, in lieu of REIT disqualification, for the failure to meet certain REIT rules in certain cases.[46] This sensible approach better matches a REIT's error with an appropriate penalty, and thereby both provides greater certainty for REIT investors and allows the IRS to better utilize its resources. The theory underlying these changes is the same as the theory underlying the "intermediate sanctions" rules Congress imposed on tax-exempt organizations.[47]

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[41] Section 414 of the Act, which conforms the definition of "hedging transaction" in § 954(c)(1)(C) (relating to foreign personal holding company income attributable to hedging transactions with respect to commodities) to the general hedging rule of § 1221, has an effective date similar to the one NAREIT is requesting for REIT hedges.
[42] §§ 856(c)(2) and (c)(3).
[43] § 856(d)(6).
[44] § 857(b)(5).
[45] § 243(e) of the Act.
[46] The IRS had issued two private letter rulings under pre-Act law that validated the use of "protective asset trusts" to prevent a REIT from inadvertently failing the 10% value test. PLRs 200132008 and 200234054. REITs that have such protective asset trusts in place may wish to reevaluate their application in light of the Act's REIT Savings provisions and consider modifying them if appropriate and permissible.
[47] § 1311(a) of Pub. L. No 104-168, adding § 4958 to the Code.

1. Asset Tests

Under prior law, a REIT that failed to satisfy certain REIT asset tests at the end of each calendar quarter was in jeopardy of losing REIT status.[48] Specifically, 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 other than in another REIT or TRS (the 10% tests)[49]; not more than 5% of a REIT's assets may consist of the securities of any one issuer other than in another REIT or TRS (the 5% test)[50]; not more than 20% of the value of a REIT's total assets may be represented by securities of one or more TRSs (the 20% test)[51]; 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)[52]; and not more than 25% of the value of a REIT's assets may be represented by "securities" (the 25% test).[53]

a. *De Minimis* Violations of the 5% and 10% Asset Tests

Under the Act, a REIT will not lose its REIT status for failing to satisfy the requirements of the 5% and 10% tests if the failure is due to the ownership of assets the total value of which does not exceed the lesser of: (i) 1% of the total value of the REIT's assets at the end of the quarter for which such measurement is done; or, (ii) $10 million. However, the REIT must either: (i) dispose of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such other time period prescribed by the Treasury); or, (ii) otherwise meet the requirements of those rules by the end of such time period.[54] There is no requirement that the failure be due to "reasonable cause," and no monetary penalty applies.

This provision is intended to relieve both the REITs and the IRS from the burden of seeking IRS approval for minor "foot faults". Although the IRS properly was flexible in retroactively correcting these *de minimis* and inadvertent failures,[55] in at least one case a secondary offering was postponed because technically a company lost its REIT status until the IRS issued retroactive relief under Treas. Reg. §301.9100-1 to allow the REIT to elect to treat a corporation as a TRS.

b. Non *De Minimis* Violations of the 5% and 10% Asset Tests, the 75% Test and Other Asset Tests

If a REIT fails to meet **any** of the asset test requirements for a particular quarter, and the failure exceeds the *de minimis* standard above, then the REIT still will be considered to have satisfied these tests if the REIT satisfies several requirements.[56]

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[48] § 856(c)(4). As stated previously, in virtually all cases, REITs obtained IRS consent to avoid loss of REIT status by securing a closing agreement or a private letter ruling.
[49] § 856(c)(4)(B)(iii)(II) and (III).
[50] § 856(c)(4)(B)(I).
[51] § 856(c)(4)(B)(ii).
[52] § 856(c)(4)(A).
[53] § 856(c)(4)(B)(i).
[54] New § 856(c)(7)(A).
[55] *See* footnote 6, *supra*.
[56] New § 856(c)(7)(B).

First, the REIT's failure to satisfy the particular asset test must be due to reasonable cause and not willful neglect.[57] Second, the REIT must provide a schedule of the offending assets to the IRS and must dispose of these assets within six months after the last day of the quarter in which it discovered an asset test violation or otherwise satisfy the relevant test[58] (or such other time period prescribed by the Treasury).[59] Finally, the REIT must pay a monetary penalty equal to the **greater of** $50,000 or a tax (treated as an excise tax) computed by multiplying the highest corporate tax rate by the net income generated by the scheduled assets for the period beginning on the first date that the failure occurs and ending on the date when the REIT no longer fails to satisfy the particular asset test.[60]

c. *De Minimis* Violations of 20%, 25% and 75% Asset Tests

The 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. Under this interpretation, a REIT that violated one of these provisions in a major 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.

This interpretation clearly is contrary to Congressional intent. Accordingly, NAREIT is seeking a clarification in a future technical corrections bill along the lines of allowing REITs to cure any asset test violations other than *de minimis* violations of the 5% and 10% asset tests by curing the violation as described in section H.1.b. above.

These REIT Savings provisions of the Act apply to taxable years beginning after the Act's date of enactment. NAREIT believes that these provisions should apply to discoveries of REIT rule violations made in taxable years beginning after date of enactment whether or not the violations began before or after the date of enactment.

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[57] The reasonable cause standard is the same found in other administrative areas of the Code such as those relating to penalties, *See, e.g.*§§ 6651(a); 6652(a)(2); 6652(b); 6652(c)(3); 6652(l); 6656(a*). See also* PLR 9550019 (reliance on law firm's opinion was reasonable cause under pre-Act income test violation. Thus, tax practitioners will need to thoroughly review these Code sections to determine whether reasonable cause exists under the REIT Savings provisions.

[58] For example, a REIT could satisfy the relevant asset test by growing its asset base and therefore increasing the denominator of a particular asset test (which would lower the percentage of nonqualifying assets owned) by the end of the six-month period.

[59] § 856(c)(7)(B)(v)(I).

[60] § 856(c)(7)(C).

2. Conformity of Rules that Apply to Failures to Satisfy the REIT Gross Income Tests

Under prior law, a REIT that failed to satisfy the 95% and 75% REIT gross income tests[61] for a particular taxable year was deemed to have satisfied these provisions if it: (i) attached a schedule to its income tax return for such taxable year that stated that nature and item of each item of gross income; (ii) the inclusion of any incorrect information in this schedule was not due to fraud with intent to evade tax; and, (iii) the failure to meet the relevant gross income test was due to reasonable cause and not willful neglect.

The Act deletes the first two requirements and inserts in their place a requirement that, following the REIT's identification of the failure to meet either of the gross income tests, a description of each item of the REIT's gross income be included in a schedule for the relevant taxable year that is filed in accordance with applicable regulations.[62] This change also applies to taxable years beginning after date of enactment.

3. Other REIT Test Violations

For REIT test violations other than the income or asset tests, the Act adds a provision that allows a REIT to retain its REIT qualification so long as the violations are due to reasonable cause and not willful neglect, and the REIT pays a penalty of $50,000 for each failure.[63]

4. Deficiency Dividends

A REIT that fails to satisfy the requirement that it distribute 90% of its REIT taxable income can satisfy this requirement if it distributes a deficiency dividend.[64] To do so, there must be a "determination" of an "adjustment" that results in the requirement to distribute a deficiency dividend.

Under prior law, the definition of "determination" was limited to a decision by the Tax Court, a closing agreement, or another type of agreement signed by representatives of IRS and the taxpayer. Accordingly, a REIT could not exercise "self help" to remedy an insufficient distribution that it noticed on its own (*e.g.*, after the tax calculations are reviewed subsequently as part of the due diligence process in a merger or acquisition). The Act expands the definition of "determination" to include a "statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year."[65] The provision is applicable to taxable years beginning after date of enactment.

A potential ambiguity is whether the law applies to determinations made with respect to pre-enactment taxable years, or determinations filed after date of enactment. It appears that the better reading of the statute is that the provisions apply with respect to determinations after date of

[61] § § 856(c)(2) and (c)(3).
[62] Section 243(f)(2) of the Act.
[63] § 856(g)(5).
[64] § 860.
[65] § 860(e)(4).

enactment. NAREIT is pursuing a clarification in a technical corrections bill that would treat the provision as applying to determinations filed after date of enactment (and therefore to errors with respect to taxable years both before and after date of enactment).

G. New Safe Harbor from 100% Tax for Timber Sales

Since 1976, the REIT rules have imposed 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, otherwise known as "dealer sales."[66] However, a safe harbor from this tax applies to sales meeting a number of criteria, including that the sold property be held for at least 4 years for the "production of rental income."[67]

Timber REITs hold land on which trees are grown, and sell trees upon their maturity. The legislative history to the Act notes the IRS' approval of timber REITs by citing a number of private letter rulings in which the IRS ruled that income from the sale of the trees can qualify as real estate-related income because the "uncut timber and the timberland on which the timber gr[ows] is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property."[68]

Timber REITs cannot use the pre-existing safe harbor because their qualifying REIT income is from the sale of timber, not from the rental of real estate. Nevertheless, timber REITs faced the same prohibited transaction rules, and their occasional disposal of real estate in the course of efficiently managing their properties subjected them to considerable uncertainty because the pre-existing safe harbor was not available to them.

The Act adds an additional safe harbor test that applies to income from timber sales.[69] This provision also applies to taxable years beginning after October 22, 2004. Under this new provision, a sale of a real estate asset by a REIT will not be a prohibited transaction if the following six requirements are met:

1) the asset has been held for at least four years in the trade or business of producing timber;
2) the aggregate expenditures made by the REIT (or REIT's partner) during the four-year period preceding the date of sale that are includible in the basis of the property (other than timberland acquisition expenditures) and that are directly related to the operation of the property for the production of timber or for the preservation of the property for use as timberland do not exceed 30% of the net selling price of the property;
3) the aggregate expenditures made by the REIT (or REIT's partner) during the four-year period preceding the date of sale that are includible in the basis of the property (other than timberland acquisition expenditures) and that are **not** directly related to the operation

[66] **§** 857(b)(6).
[67] **§** 857(b)(6)(C)(iv).
[68] H.R. Rep. No. 755, 108th Cong., 2d Sess. 309 (2004). The Conference Report further notes that "[a] private letter ruling may be relied upon only by the taxpayer to which the ruling is issued. However, such rulings provide an indication of administrative practice."
[69] § 321 of the Act.

of the property for the production of timber or for the preservation of the property for use as timberland do not exceed 5% of the net selling price of the property;
4) generally, the REIT either (a) does not make more than seven sales of property or (b) the aggregate adjusted bases of property sold during the year does not exceed 10% of the aggregate bases of property all of the assets of the REIT as of the beginning of the year;
5) substantially all of the marketing expenditures with respect to the property are made by independent contractors from which the REIT does not derive income; and,
6) the sales price of the property is not based on the income or profits of any person.[70]

As with the pre-existing safe harbor, a REIT still can continue to not be subject to the 100% excise tax if it demonstrates on a facts and circumstances basis that the transaction is not a dealer sale.[71]

H. Treatment of Foreign Investors in REITs

1. Background

Under the part of the Code called the Foreign Investment in Real Property Tax Act (FIRPTA), gain or loss of a foreign person from the disposition of a U.S. real property interest (USRPI) is taken into account for U.S. tax purposes as though such gain or loss were effectively connected (effectively connected income, or ECI) with a U.S. trade or business during the taxable year.[72] Foreign persons that realize such gain or loss must file a U.S. tax return. [73]

Prior to the Act, a foreign shareholder's receipt of a distribution from a REIT was treated as a gain from the disposition of a USRPI to the extent it was attributable to gain from the sale or exchange of a USRPI by the REIT.[74] These capital gain distributions from a REIT generally were subject to a 35% withholding tax, and a non-U.S. recipient of such distributions was required to file a U.S. income tax return merely by virtue of receiving a REIT capital gain distribution. In addition, if the recipient was treated for U.S. tax purposes as a corporation, it may have been required to pay a "branch profits" tax solely because of such distribution.[75]

This treatment of capital gains distributions was inconsistent with Congress' original decision when it enacted FIRPTA, since FIRPTA does not apply to a non-U.S. person's sale of stock of a listed U.S. REIT so long as the non-U.S. person owns 5% or less of the REIT's stock in the five-year period before the sale.[76] Further, this treatment of REIT capital gains placed listed REITs at a competitive disadvantage in the marketplace since, as a general matter, overseas investors

[70] § 857(b)(6)(D), as added by the Act.
[71] § 857(b)(6)(B)(iii). A more detailed explanation of the safe harbor is provided in H.R. Rep. No. 755, 108th Cong., 2d Sess. 311-12 (2004).
[72] § 897.
[73] § 6012.
[74] § 897(h)(1).
[75] § 884. Several bilateral tax treaties eliminate or reduce branch profits tax liability.
[76] § 897(c)(3). As an aside, FIRPTA also does not apply to a foreign shareholder's sale of stock in a "domestically-controlled REIT." § 897(h)(2). Generally, a "domestically-controlled REIT" is a REIT less than 50% of the value of the stock of which is held by foreign persons over a five-year look-back period. § 897(h)(4)(B). The Act changed the nomenclature of this type of REIT to "domestically controlled qualified investment entity." See footnote 88, *infra*.

never have to file U.S. tax returns merely because they receive dividends from non-REIT U.S. corporations.

2. The Act

The Act treats a REIT capital gain distribution to a foreign investor as if it were an ordinary income dividend for FIRPTA purposes if: (1) the distribution is with respect to stock that is publicly traded on a U.S. exchange; and, (2) the foreign investor owns 5% or less of the class of stock at all times during the taxable year when such distribution is made.[77]

Accordingly, foreign portfolio investors in listed U.S. REITs no longer are under an obligation to file U.S. tax returns (or pay branch profits tax) solely because of REIT capital gains distributions, and such distributions can qualify for the lower U.S. withholding amounts applicable to ordinary dividends under U.S. bilateral tax treaties.[78] This change, applicable for taxable years after date of enactment, allows listed U.S. REITs to provide the same tax treatment to foreign portfolio investors that applies to all non-U.S. investors in non-REIT U.S. corporations.

3. Open Issues

There are two open issues relating to this provision. First, it is unclear whether the FIRPTA change applies to the recipient shareholder's taxable year beginning after the date of enactment or the REIT's taxable year beginning after the date of enactment. Almost all REITs are calendar year taxpayers, but shareholders may be fiscal year taxpayers. For example, a calendar year REIT might make a capital gain distribution on December 15, 2004 (after the Act's enactment) to a fiscal year shareholder whose taxable year begins December 1. It is not clear whether the new provision applies to this distribution.

On November 19, 2004, House Ways & Means Chairman Bill Thomas (R-CA), Senate Finance Committee Chairman Chuck Grassley (R-IA) and Ranking Member Max Baucus (D-MT) introduced H.R. 5395, the "Tax Technical Corrections Act of 2004" (TTCA 2004). TTCA 2004 would provide that the Act's changes to § 897 apply to any distributions by a REIT that are treated as deductions by such REIT with respect to any taxable year after the Act's date of enactment. This change would provide better administrative certainty both to REITs and other withholding agents.

Specifically, § 2(a)(6)(B) of H.R. 5395 would apply the REIT FIRPTA change to "any distribution by a [REIT] which is treated as a deduction for a taxable year of such [REIT] beginning after the date of enactment of [H.R. 5395]." While this provision provides additional clarity, it raises the issue of whether a foreign shareholder that receives a deficiency dividend paid by a REIT in a year subsequent to the Act (*e.g.,* 2006) that relates to a year prior to the Act (*e.g.*, 2003) would be subject to 35% withholding tax and the requirement to file a tax return under pre-Act law. A deficiency dividend paid with respect to an earlier year is deductible in that

[77] § 897(h)(1), as amended by the Act.
[78] See also http://www.afire.org/newsletter/2004/ajca.shtm. Note that § 892 provides that foreign government entities generally pay no U.S. tax on dividends from U.S. corporations, including REITs.

earlier year.[79] NAREIT believes that the new FIRPTA REIT rule should apply to any capital gains distributions a REIT makes as part of a deficiency dividend made in taxable years beginning after October 22, 2004. TTCA 2004 does not include this change.

The second issue relates to the calculation of whether a REIT's shareholder owned more than 5% of that class of the REIT's stock "at any time during the taxable year." Many publicly traded REITs already track those shareholders that own in excess of 5% of their stock for purposes of the REIT ownership rules by monitoring the filings of Schedules 13D and 13G with the Securities and Exchange Commission on an annual basis. Requiring these REITs to use a different twelve-month period for tracking purposes would create significant confusion.

To avoid confusion in monitoring shareholders who own more than 5% of REITs, NAREIT supports a clarification in a technical correction bill under which the Act's change to § 897 would apply to any REIT shareholder that owned more than 5% of that class of the REIT's stock by reference to the distributing REIT's taxable year. TTCA 2004 does not include this change.

IV. NON-REIT PROVISIONS

A. Leasehold Improvements

The Act also includes a provision that reduces the recovery period for second-generation leasehold improvements placed in service after the date of enactment through 2005 from 39 years to 15 years.[80] NAREIT, along with many other national real estate organizations, has long sought a permanent reduction in the recovery period for leasehold improvements from 39 to 10 or 15 years.[81] While the Act contains the recovery period deduction only for improvements placed in service in the end of 2004 and in 2005, its inclusion of this reduction in legislation at all is notable and may facilitate an extension of the provision to years after 2005.

Because the shortened recovery period only applies for purposes of computing REIT taxable income, and not for computing earnings and profits, for those REITs that utilize the shortened recovery period, there are likely to be situations in which their taxable income is lower than their earnings and profits. If so, distributions to shareholders in excess of taxable income would not be in excess of earnings and profits, and, thus, would be treated as dividends to shareholders, resulting in shareholders' paying tax on amounts in excess of a REIT's taxable income.[82] Working with other real estate groups, NAREIT will seek to address this issue in future leasehold improvement legislation.

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[79] § 860(a).
[80] § 211 of the Act.
[81] *See* H.R. 1634, introduced by Representatives Clay Shaw (R-FL) and Richard Neal (D-MA) on April 3, 2003, which attracted a total of 84 co-sponsors, and S. 576, introduced March 7, 2003 by Senators Don Nickles (R-OK) and Kent Conrad (D-ND), which attracted a total of 13 co-sponsors.
[82] Deductions after the 15-year recovery period expires for tax purposes will be ignored by virtue of § 857(d), which disallows deductions from earnings and profits that are not allowable for purposes of computing taxable income. As a result, shareholders will face double counting of income – additional income in earlier years due to the mismatch between the taxable income and earnings and profits recovery periods and additional income due to the application of § 856(d) once the 15-year recovery period expires.

B. FIRPTA and Mutual Funds

1. Pre-Act: FIRPTA's Application to Shares in Mutual Funds and Capital Gain Dividends by Mutual Funds

Before the Act, FIRPTA generally did not apply to either: (i) the sale of stock by a foreign shareholder in a regulated investment company (herein, a mutual fund); or, (ii) the capital gain dividends by mutual funds attributable to capital gain dividends from REITs. Theoretically, FIRPTA could apply to sales of mutual fund shares by foreigners only with respect to mutual fund that was a "United States Real Property Holding Corporation" (USRPHC) (*i.e.*, more than 50% of its assets were U.S. real property interests, or USRPIs).[83] As a practical matter, however, even dedicated REIT mutual funds were unlikely to be USRPHCs because either: (i) the REIT shares owned were publicly traded, and the mutual fund held 5% or less of such shares over the relevant look-back period;[84] or, (ii) the REIT shares were held in "domestically-controlled REITs." [85] In both cases, the REIT shares would not be considered USRPIs.

2. Pre-Act: FIRPTA's Application to Sales of Shares in REITs and REIT Capital Gain Dividends

As noted in Section III.H.1 above, prior to the Act, FIRPTA could apply to the sale of stock by a foreign shareholder in a REIT unless either: (i) generally speaking, the foreign shareholder held 5% or less of the REIT's stock at all times during a five-year look-back period; or, (ii) the REIT was a "domestically-controlled REIT" during the look-back period. § 897(h)(1) treated a foreign shareholder's receipt of a REIT capital gain dividend attributable to dispositions by the REIT of United States real property interests as a disposition of a USRPI by the foreign shareholder (the FIRPTA Look-Through Rule), but it applied only to capital gain dividends paid by REITs to foreign shareholders, not by REITs and mutual funds.

3. Act's Modification of FIRPTA Provisions for REIT Capital Gain Dividends

As noted in Section H. above, the Act modified the FIPRTA provisions of the Code with respect to REIT capital gain dividends by exempting from FIRPTA REIT distributions from publicly traded REITs to foreign shareholders that own 5% or less of the REIT over a twelve-month period. [86]

[83] § 897(c)(1) and (2).
[84] § 897(c)(3).
[85] § 897(h).
[86] § 418(a) of the Act.

4. FIRPTA Changes in the Act Affecting Mutual Funds

The Act made three changes in the FIRPTA area that affect mutual funds. First, the Act extended the exception from FIRPTA for sales in "domestically-controlled REITs" to domestically controlled mutual funds.[87] Second, the Act extended most of the FIRPTA provisions of the Code relating to REITs to mutual funds by substituting the term "qualified investment entity" for "REIT" in a number of places in § 897 so that "qualified investment entity" includes both REITs and mutual funds. [88] Third, the Act expanded the FIRPTA Look-Through Rule to include capital gain dividends by a mutual fund attributable to dispositions of USRPIs by the mutual fund.[89] These three changes take effect after December 31, 2004 and expire December 31, 2007.

The Act's change to the FIRPTA Look-Through Rule means that to the extent a mutual fund sells shares in a USRPHC and distributes the gain from such sale to a foreign shareholder, the mutual fund, possibly pending regulations, might have to withhold a 35% tax from such distribution,[90] and the foreign shareholder will have to file a U.S. income tax return with respect to such distribution. This change requires mutual funds to know whether their portfolios include shares of companies that are treated as USRPIs.

As noted earlier, shares in REITs will not be treated as USRPIs so long as the relevant REIT has been a "domestically-controlled REIT" over a five-year look-back period,[91] or the REIT stock is publicly traded and the mutual fund has held 5% or less of the REIT's stock over the look-back period (after application of constructive ownership rules).[92] For mutual funds that own shares in public, non-REIT C corporations that may be considered USRPHCs (because of extensive U.S. real property holdings), again, such shares will not be considered USRPIs so long as the mutual fund has held 5% or less of the corporation's stock over the look-back period (after application of constructive ownership rules).

[87] Thus, the sale by a foreign shareholder of shares of a mutual fund will not be subject to FIRPTA so long as that mutual fund is "domestically-controlled."

[88] § 411 of the Act.

[89] § 897(h)(1), as amended by the Act. The FIRPTA Look-Through Rule now reads: "[a]ny distribution by a qualified investment entity to a nonresident alien individual or foreign corporation shall, to the extent attributable to gain from sales or exchanges by **the** qualified investment entity of [USRPIs], be treated as gain recognized by such nonresident alien individual or foreign corporation from the sale or exchange of a [USRPI]" (emphasis added). While it may be argued that this provision extends FIRPTA to a capital gain dividend by a mutual fund attributable to capital gain dividend by REIT, the far better reading is that this provision of the Act extends FIRPTA only to a mutual fund's capital gain dividends attributable to that mutual fund's dispositions of USRPIs.

[90] The Treasury Department may have to issue regulations that specifically require mutual funds to withhold from such distributions. Existing regulations only apply to REITs because the pre-Act statute only applied to capital gain distributions by REITs.

[91] §897(h)(2).

[92] §897(c)(3).

5. Mutual Funds May Seek Legislative Remedy for Capital Gain Dividends Similar to Act's Change for Portfolio Investors of Publicly Traded REITs

We understand that at least some mutual funds are not comfortable relying on the "domestically-controlled qualified investment entity" exception to FIRPTA because in the public markets, it is difficult to be certain whether a listed company is in fact "domestically-controlled." Similarly, because constructive ownership rules apply to determine whether a mutual fund has held more than 5% of a publicly traded corporation's stock at any time over a look-back period,[93] it is difficult to say with absolute certainty whether a mutual fund has not owned during the relevant look-back period more than 5% of any company in its portfolio that could be treated as a USRPHC (*e.g.*, a REITs or C corporation with large property portfolio).

As a result of these practical difficulties for mutual funds, the mutual fund trade association may pursue a legislative change with respect to these issues that may be similar to the Act's exemption from FIRPTA of REIT capital gain dividends by publicly traded REITs to portfolio investors.[94]

C. Deduction for Construction Activities

The Act permits a taxpayer to claim a deduction from taxable income ranging from 3% in 2005 to 9% in 2010 of the lesser of: (i) the taxpayer's "qualified production activity income" for the taxable year, or, (ii) the taxpayer's taxable income for the taxable year.[95] "Qualified production activity income" includes, among other things, the gross receipts from construction activities performed in the U.S.

Thus, to claim this deduction, a REIT would need to realize gross receipts from construction activities. We understand that some non-REIT taxpayers are asking the Treasury Department to issue guidance concluding that construction activities include activities of a taxpayer in which the taxpayer acts as a general contractor.

[93] Of course, this exception would be unavailable to those mutual funds that have in fact owned more than 5% of a publicly traded REIT's (or other USRPHC's) stock at any time over the look-back period.
[94] As noted above, TTCA 2004 contains a provision that modifies the effective date of the Act's change to the FIRPTA rules for REIT capital gain dividends. In describing this provision, the tax staff of the Joint Committee on Taxation specifically stated that it does not apply to capital gain dividends from mutual funds. The description states: "[t]he provision provides that [mutual funds] are not eligible for the exception from FIRPTA that the Act provides for REITs in the case of distributions to five-percent-or-less shareholders." Joint Committee on Taxation, *Description of the Tax Technical Corrections Act of 2004* (JCX-70-04), November 19, 2004 at 4. Thus, mutual funds would appear to need additional legislation to secure this (or another) exception from FIRPTA with respect to capital gain dividends from mutual funds.
[95] § 199 of the Act.