June 17, 2004

national policy
bulletin

National Association of Real Estate Investment Trusts®

House Passes International Tax Reform Bill With Several REIT Improvements

Today, the House of Representatives approved the "American Jobs Creation Act of 2004," H.R. 4520. H.R. 4520 would significantly reform the way the United States taxes domestic taxpayers operating abroad and foreign taxpayers operating and investing in the United States. H.R. 4520 also is known as the "FSC/ETI Bill" because it would modify the FSC/ETI (foreign sales corporation/extraterritorial income) tax provisions of the Tax Code. For the text of H.R. 4520 and the Ways and Means Committee Report, CLICK HERE.

As described below, H.R. 4520 incorporates several provisions contained in H.R. 1890, the NAREIT-supported Real Estate Investment Trust Improvement Act of 2003 (RIA). First, H.R. 4520 includes most of Title I of the RIA that would allow, among other things, a REIT to make certain loans in the ordinary course of business without the risk of losing REIT status. H.R. 4520 also incorporates Title III of the RIA, which would allow REITs to avoid REIT disqualification for non-intentional REIT test violations either by paying a monetary penalty if the violation was due to reasonable cause or, for certain *de minimis* violations, bringing themselves into compliance with the REIT rules. S. 1637, the Senate companion bill to H.R. 4520 that passed last month, incorporates: 1) Title II of the RIA, concerning "FIRPTA" and applicable to reporting requirements of foreign investors in U.S. REITs; and 2) a provision from Title I of the RIA that would allow timber sales to qualify for a safe harbor from the 100% prohibited transactions tax. For more information on the RIA, CLICK HERE.

SUMMARY OF THE RIA PROVISIONS IN H.R. 4520

Improvements to REIT Modernization Act of 1999 (RMA)

For purposes of the limitation that a REIT own not more than 10% of an issuer's "securities" (including certain debt "securities"), Title I of the RIA would modify the Internal Revenue Code's definition of "straight debt," which is excluded from this limit. H.R. 4520 would also include as falling outside of the 10% "vote or value" test debt, the repayment of which could be conditioned upon cash flow, and would provide a number of specific *per se* exemptions to this asset test. The proposed language also contains technical corrections related to rent received from taxable REIT subsidiaries (TRSs) as well as provisions that would update certain rules that apply to currency and other hedges and would make other technical changes to the RMA.

The "straight debt" clarifications and TRS rental provisions would be effective for taxable years beginning after December 31, 2000 (the same effective date as the RMA), while the other provisions would be effective for taxable years beginning after date of enactment. H.R. 4520 does not contain a provision from Title I of the RIA that would allow certain sales of timber to qualify for the safe harbor from the 100% prohibited transactions tax. That provision is contained in the Senate companion bill to H.R. 4520, S. 1637.

Monetary Penalties in Lieu of REIT Disqualification for Reasonable Cause Violations of the REIT Rules

Under current law, a company faces the loss of REIT status even for an unintentional violation of a number of REIT rules. H.R. 4520 includes Title III of the RIA (also known as "REIT Savings") under which a REIT would instead be assessed a monetary penalty of $50,000 for each reasonable cause failure to satisfy the REIT rules other than the asset test.

For violations of the asset test, in lieu of disqualification a REIT would be given an opportunity to correct the violation within six months of the last day of the calendar quarter after it was discovered with respect to assets that do not exceed the lesser of 1% of its total assets or $10 million. In other words, no monetary penalty would apply to *de minimis* violations of the asset test. Assets in excess of the *de minimis* 1% amount or $10 million would be subject to a tax of the greater of $50,000 or the highest corporate tax rate multiplied by the net income from the assets if the violation was justified by reasonable cause. If the violation were intentional, the company would continue to face loss of REIT status.

SUMMARY OF THE RIA PROVISIONS IN S. 1637, COMPANION BILL TO H.R. 4520

As noted above, the Senate companion bill to H.R. 4520 contains two provisions of the RIA that are not contained in H.R. 4520: Title II of the RIA, concerning foreign investors in U.S. REITs and a provision from Title I of the RIA concerning a safe harbor from the 100% prohibited transaction tax for timber sales.

Modifications to Treatment of Foreign Investors in REITs

Under current law, a foreign investor who receives a REIT capital gain distribution is treated as engaged in a U.S. business under the Foreign Investor in Real Property Tax Act (FIRPTA) provisions of the Internal Revenue Code. Accordingly, the distributing REIT must withhold a 35% tax on the distribution, while the investor is required to file a U.S. tax return and may be required to pay a "branch profits" tax solely because of such distribution.

Under Title II of the RIA that is included in S. 1637, the capital gains distributions of a publicly traded REIT to a non-U.S. investor would be treated as ordinary dividends so long as the investor owns 5% or less of the distributing REIT. Consequently, the investor would not be required to file a U.S. tax return, the branch profits tax would not apply, and the distributing REIT would withhold at a 30% rate or a lower rate prescribed by bilateral treaties. CLICK HERE to view the withholding rates broken down by country of shareholder residence. These provisions would be effective for taxable years beginning after date of enactment.

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

Current law imposes a 100% tax on a REIT's net income from "prohibited transactions," *i.e.*, the disposition of property that is held for sale in the ordinary course of the taxpayer's trade or business. However, a safe harbor from this tax can apply to property held for at least 4 years for the "production of rental income."

Current law prevents timber REITs from using the existing safe harbor because their qualifying REIT income is from the sale of timber, not from the rental of real estate. Nevertheless, timber REITs face the same prohibited transaction rules, and their occasional disposal of real estate in the course of efficiently managing their properties subjects them to considerable uncertainty because the safe harbor is not available to them. S. 1637 includes a provision that would add an additional safe harbor test that applies to income from timber sales. This provision also would apply to taxable years beginning after date of enactment.

Outlook

Following a decision by the World Trade Organization (WTO) that the FSC/ETI provisions of the U.S. tax code were illegal, the European Union imposed a tarriff on some U.S. exports now at 8% and set to increase by an additional 1 percentage point a month, up to a maximum of 17%. If the FSC/ETI bill becomes law, this penalty would be removed.

Now that both the House and Senate have passed their versions of a FSC/ETI repeal, the next step is for both bills to be reconciled by a conference committee of members from both legislative bodies. At the current time, it is not clear whether or when the Senate Democrats will allow conferees to be appointed. If these bills go to conference, NAREIT will work with the conference committee to incorporate all three titles of the RIA into the final bill.

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

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