Concurrent Session: REIT Tax Big Brains Conversation

Friday, March 24th
11:00am – 12:15pm
La Quinta Resort & Club, La Quinta, California

Moderator:
Scott Winer, SVP-Tax, Park Hotels & Resorts

Panelists:
Adam Feuerstein, Principal, PwC
Joseph Howe, Partner, Arnold & Porter, LLP
Christopher Mangin, Jr., Partner, Vinson & Elkins LLP
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REIT Wise® 2017

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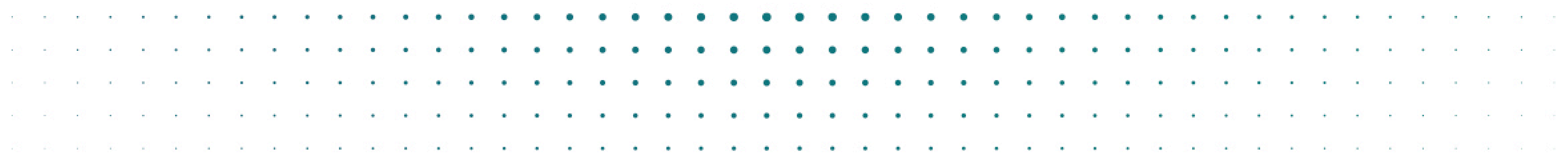
REIT Tax Big Brains Conversation



Presenters

- Moderator:
  - Scott Winer, SVP-Tax, Park Hotels & Resorts
- Panelists:
  - Adam Feuerstein, Principal, PwC
  - Joseph Howe, Partner, Arnold & Porter, LLP
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  - Ana O'Brien, Partner, Latham & Watkins LLP

Agenda

- Subsidiary REITs
- Constructive Ownership and Related Party Rents
- Intangible Assets

Reasons for Forming Subsidiary REITs

- Tax-exempt entities may wish to own real estate through a REIT, since dividend income generally does not constitute UBTI.
- Non-U.S. persons may invest in U.S. real estate through a “domestically controlled” REIT to minimize U.S. income taxes on operating income and, possibly, upon the sale of the property.
  - PATH Act legislation provides additional flexibility.
- An UPREIT engaging in a TMP securitization may form a subsidiary REIT so the TMP will be treated as a QRS.

Impact on Public Parent REIT

- A subsidiary REIT's failure to qualify as a REIT can adversely affect its public parent's REIT status.
  - Interests in the subsidiary would be subject to the 5%,10% and 25% Asset Tests.
  - Dividends would no longer be qualifying income for purposes of the 75% income test.

Board Management

- Who qualifies as a “director” or “trustee” of a non-corporate REIT for purposes of Section 856(a)(1)?
  - Manager of an LLC or GP of a partnership?
  - What types of rights and obligations are required?
- Consider timing of deemed election under Treas. Reg. Section 301.7701-3(c)(1)(v)(B) or as a result of filing of IRS Form 8832.

100 Shareholders

- A REIT is required to have 100 shareholders at least 335 days in a taxable year (or a proportionate part of the taxable year).
  - This requirement does not need to be met for the first taxable year.
  - Consider putting stockholders in place in the first year if the REIT may be sold or liquidated in the second year.
- One needs to be comfortable that the shareholders will be respected as such.
- Preferential dividend rules still applicable
  - Make sure the terms of each class of stock will not raise preferential dividend issues in practice.
- Consider whether the issuance of a second class of stock to satisfy the requirement will affect the taxation of the contribution of appreciated property.

Corporate Formalities and Cash Management

- Steps should be taken so that the separateness of a subsidiary REIT will be respected.
- The subsidiary REIT should enter into agreements on its own account.
- Cash Management
  - Bank accounts should be maintained at subsidiary REIT.
  - Cash from preferred issuance should be deposited into subsidiary REIT.
  - Cash management between the subsidiary REIT and other entities should be carefully documented.

Dividend Payments

- Preferential dividend rules still apply to subsidiary REITs
  - Preferred dividends must be declared and paid on time.
  - If more than one common holder, each common holder should receive payment at same time.
- Beware certain state DPD statutes
  - Some states disallow a state-level DPD for “captive” REITs
    - Trap for the unwary in the case of purchase of single asset REIT followed by liquidation
- Consider impact of distributions from subsidiary REITs to the shareholders of a parent REIT

Transferability of Shares

- Best Practice: no restrictions, but may not be realistic from business perspective.
- Other Options:
  - Shareholders' Agreement to which REIT is not a party
    - Transfer of shares with consent of non-transferring shareholders, not to be unreasonably withheld.
    - ROFO/ROFR
  - Restrictions on transfer at partnership level above the REIT
    - Partnership remains free to transfer shares in the REIT

Contribution of Property

- 368(c) control: ensure parent owns 80% of each class of stock, including preferred.
- Beware potential "busted" 351 in connection with actual or deemed contribution.
  - Contribution by one party to REIT, followed by sale of shares sufficient to break control to another party
    - Step transaction: binding commitment; end result; interdependence.
  - Contributions of non-identical assets may result in diversification.

Mechanics and Tax Consequences of Liquidating

- Redeem preferred shares
  - Beware proportionate 100 shareholders rule for short year
    - Redeem preferred shares close in time to liquidation
- Mechanics
  - “uncheck” the box (if possible)
  - Otherwise, merge entity with and into OP or another disregarded sub
- Liquidation treated as sale/exchange from shareholder (OP or Parent REIT) perspective
  - Gain to shareholder measured by difference between basis in REIT stock and FMV of assets received.

Mechanics and Tax Consequences of Liquidating *(con't)*

- Liquidation triggers gain at lower-tier REIT in the amount of the difference between FMV of assets and tax basis of assets.
- REIT gets DPD for distribution of assets
  - Ensure DPD is sufficient to eliminate gain plus any remaining taxable income for REIT's final year
    - Consent dividend to eliminate remaining income if necessary
  - Beware state statues that can disallow DPD at state level for "captive" REITs
    - This trap for the unwary can result in taxable gain at the state level

Constructive Ownership of Stock

- For purposes of determining whether rents may be excluded from "rents from real property" under the related party exclusion in § 856(d)(2)(B); and
- For purposes of determining whether a person may qualify as an "independent contractor" as defined in § 856(d)(3), or an "eligible independent contractor " § 856(d)(9),
- The rules prescribed in § 318(a) for determining ownership of stock shall apply in determining the ownership of stock, assets or net profits of any person with certain modifications.

Constructive Ownership of Stock *(con't)*

- § 856(d)(5) modifies § 318(a) for these purposes to lower the 50% threshold to 10% increasing possible upward and downward attribution and modifies attribution from a partner to a partnership by taking into account only partners who own (directly or indirectly) 25% or more of the capital interest or the profits interest in the partnership

- The constructive ownership rules may apply in the case of a TRS held by a REIT as there is no exception from § 318(a) attribution from or to a TRS

- The constructive ownership rules of § 318(a) provide for attribution to and from family member and to and from entities and for certain operating rules in applying the attribution rules, such as

Constructive Ownership of Stock *(con't)*

- Stock constructively and owned by a person due to attribution to the person shall be considered as actually owned by such person
- *Accordingly, there can be Re-attribution except as limited by other operating rules*
- Stock constructively owned by a partnership, estate, trust, or corporation by reason of attribution to such entity (downward attribution) shall not be considered as owned by such entity for purpose of attributing upward such stock in order to make another the constructive owner of such stock

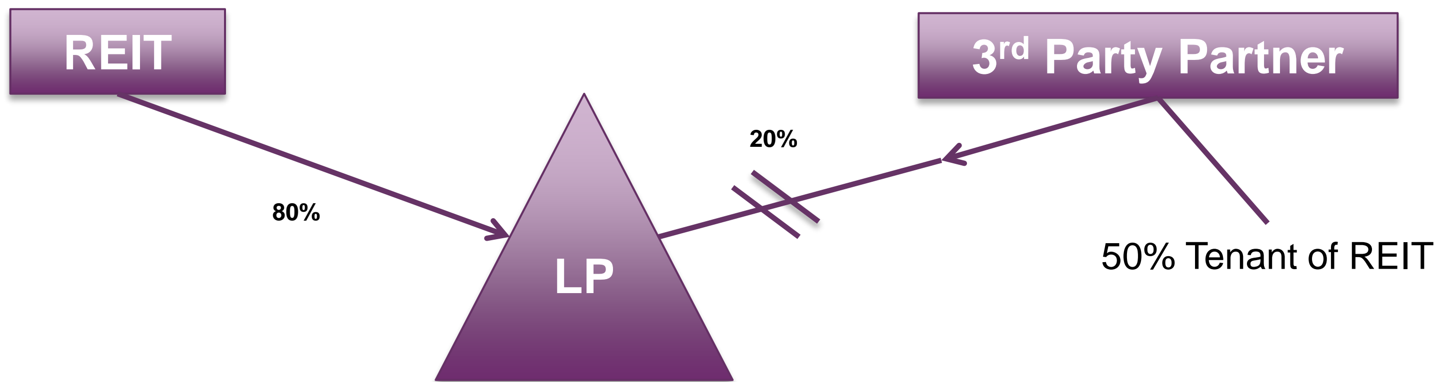
Constructive Ownership of Stock *(con't)*

- *Accordingly, stock attributed by a partner to a partnership will not be attributed upward to another partner of the partnership; however, the operating rule does not preclude downward attribution*
- If any person has an option to acquire stock, such stock shall be considered as owned by such person.
- Consider Rev. Rul. 74-605

Safeguards and Best Practices

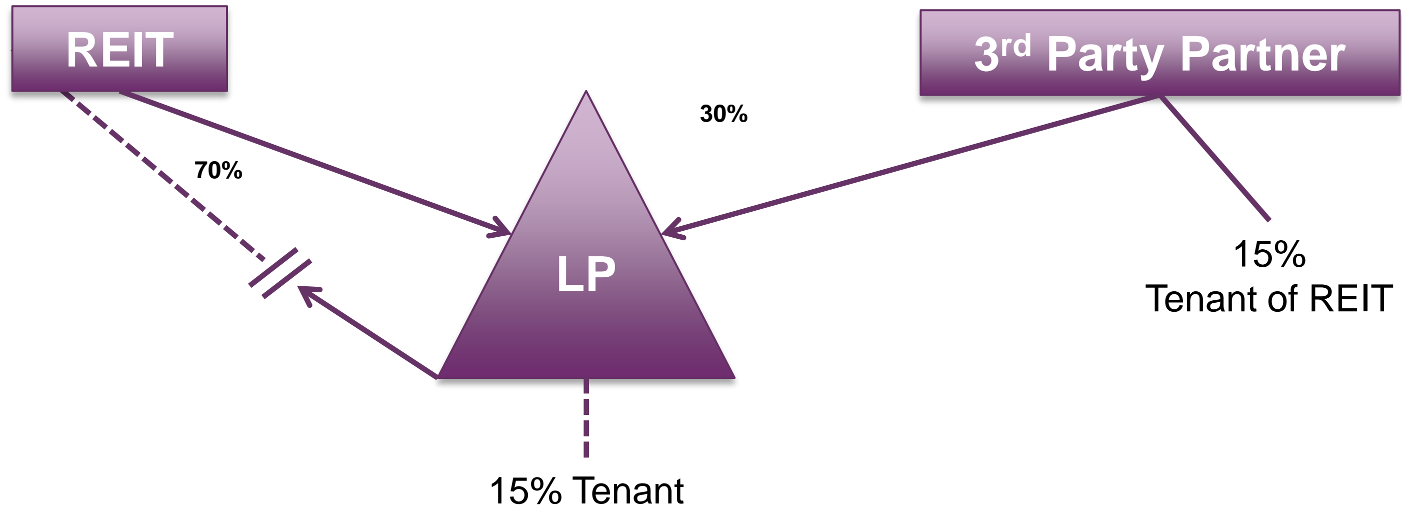
- Excess Share provisions in Articles
- Waivers of ownership limitations in the Articles need a mechanism to protect against related party rents
- REIT protective provisions in joint venture agreements and partnership agreements
- Limitation on the effectiveness of such safeguards in complex structures

§ 318(a)(3)(A) as modified by § 856(d)(5)(B)



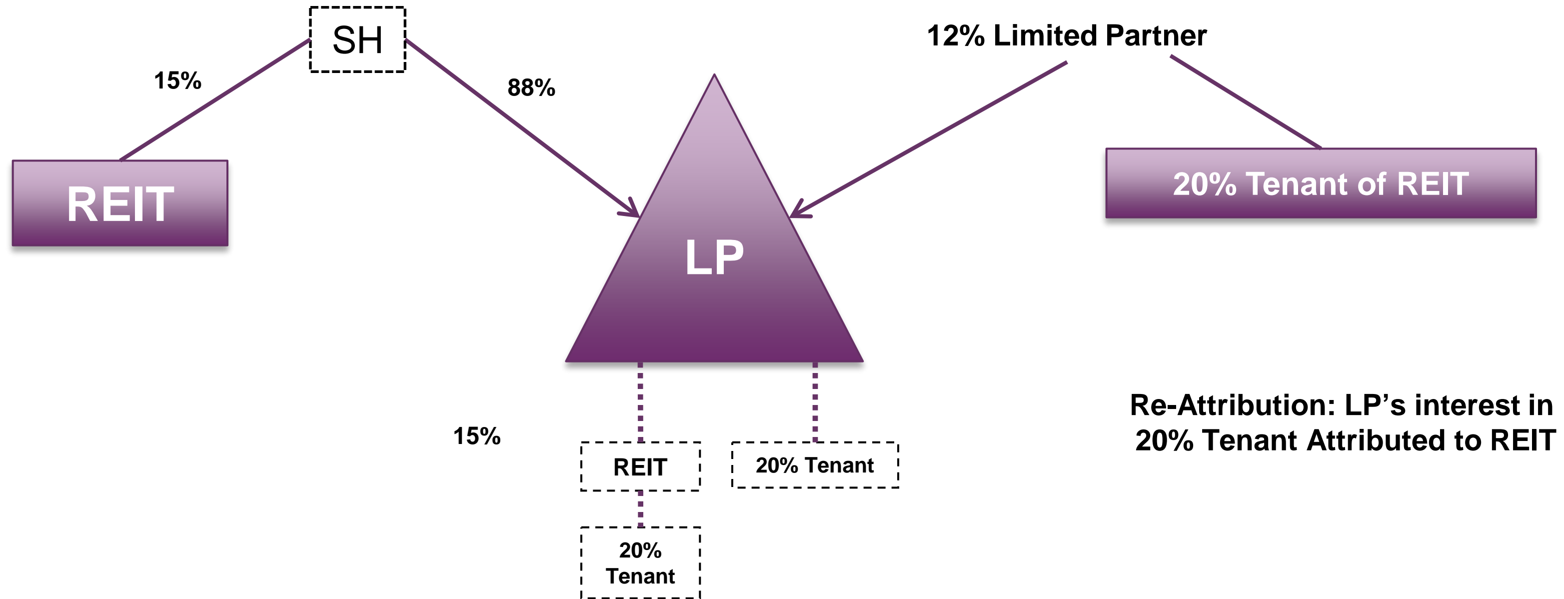
No attribution of Tenant to LP as 3rd Party Partner owns less than a 25% interest in the LP

§ 318(a)(5)(C) -- Operating Rule



Through attribution of the 15% Tenant to LP, there is no further upward attribution to REIT due to § 318 operating rule.

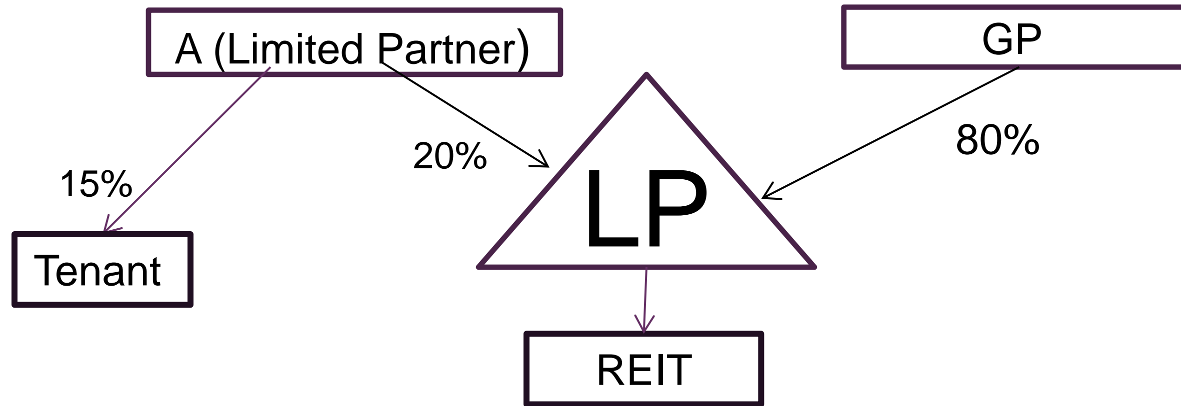
Re-Attribution Prior to 1997 – Impetus for § 856 (d)(5)(B)



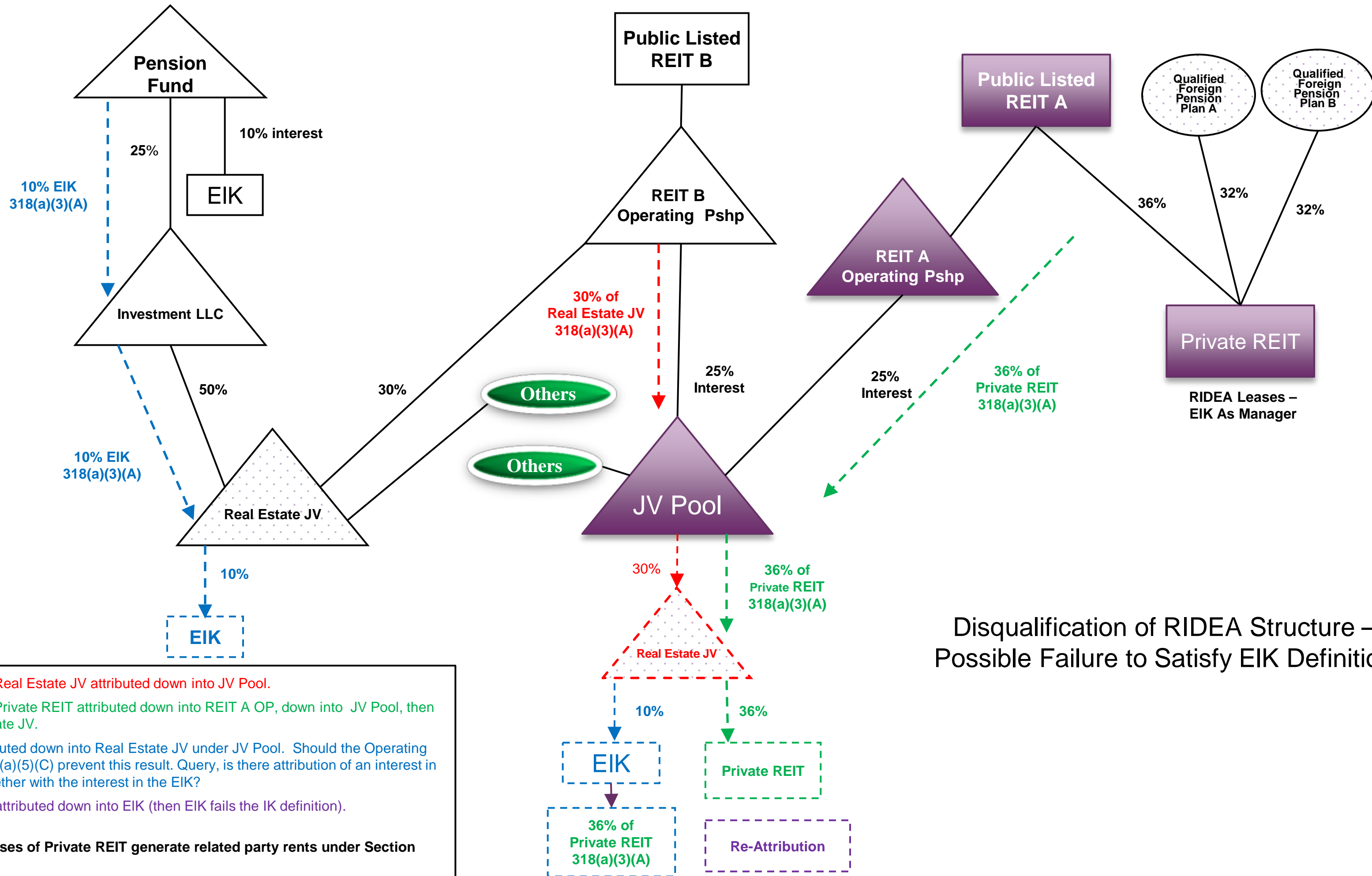
Re-Attribution: LP's interest in 20% Tenant Attributed to REIT

Post 1977 – There would be no attribution to the LP due to the 25% gate (§ 318(a)(3)(A) as modified by § 856(d)(5)(B)).

However, if the limited partner held a 25% interest in the LP, than Re-attribution would apply. The operating rule of § 318(a)(5)(C) does not protect against downward attribution.



- JCT Explanation (Example): 1997 Modification providing for the 25% gate:
- "Thus, a REIT and a tenant will not be treated as related (and, therefore, rents paid by the tenant to the REIT will not be treated as nonqualifying rents) if the REIT's shares are owned by a partnership and a partner owning a directly and indirectly less-than-25-percent interest in that partnership also owns an interest in the tenant.“
- However, if the shares of the REIT held by the LP are attributed to A, and if the shares held by A in the tenant are attributed to the REIT, then the rent paid by the tenant will be treated as non-qualifying rents. This separate attribution path disqualifies the tenant even though A owns less than 25% of LP.

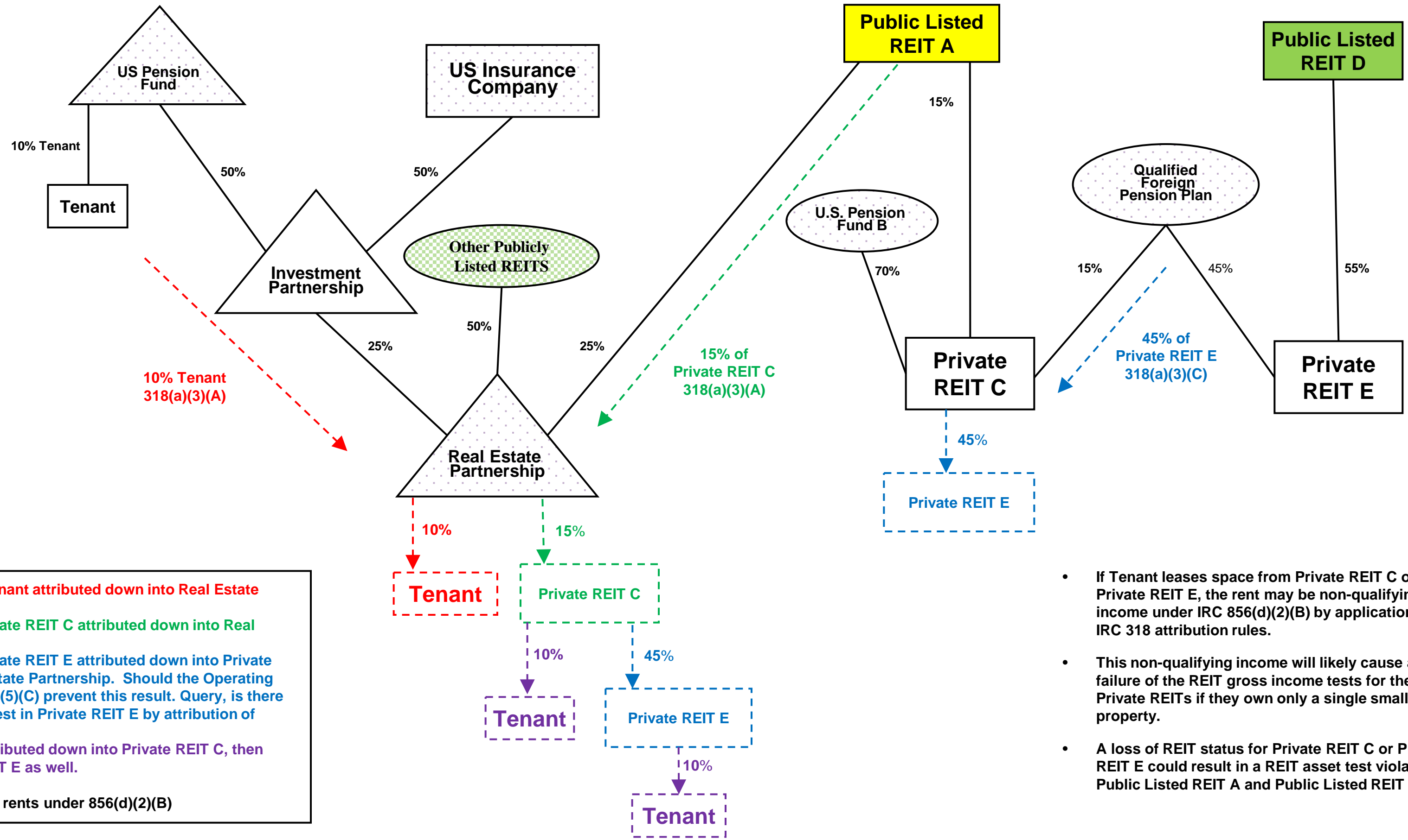


1. 30% interest in Real Estate JV attributed down into JV Pool.
2. 30% interest in Private REIT attributed down into REIT A OP, down into JV Pool, then down into Real Estate JV.
3. EIK (10%) attributed down into Real Estate JV under JV Pool. Should the Operating Rule in Section 318(a)(5)(C) prevent this result. Query, is there attribution of an interest in Real Estate JV together with the interest in the EIK?
4. If Private REIT attributed down into EIK (then EIK fails the IK definition).

Result: RIDEA leases of Private REIT generate related party rents under Section 856(d)(2)(B).

Disqualification of RIDEA Structure – Possible Failure to Satisfy EIK Definition

Related Party Rents (1)

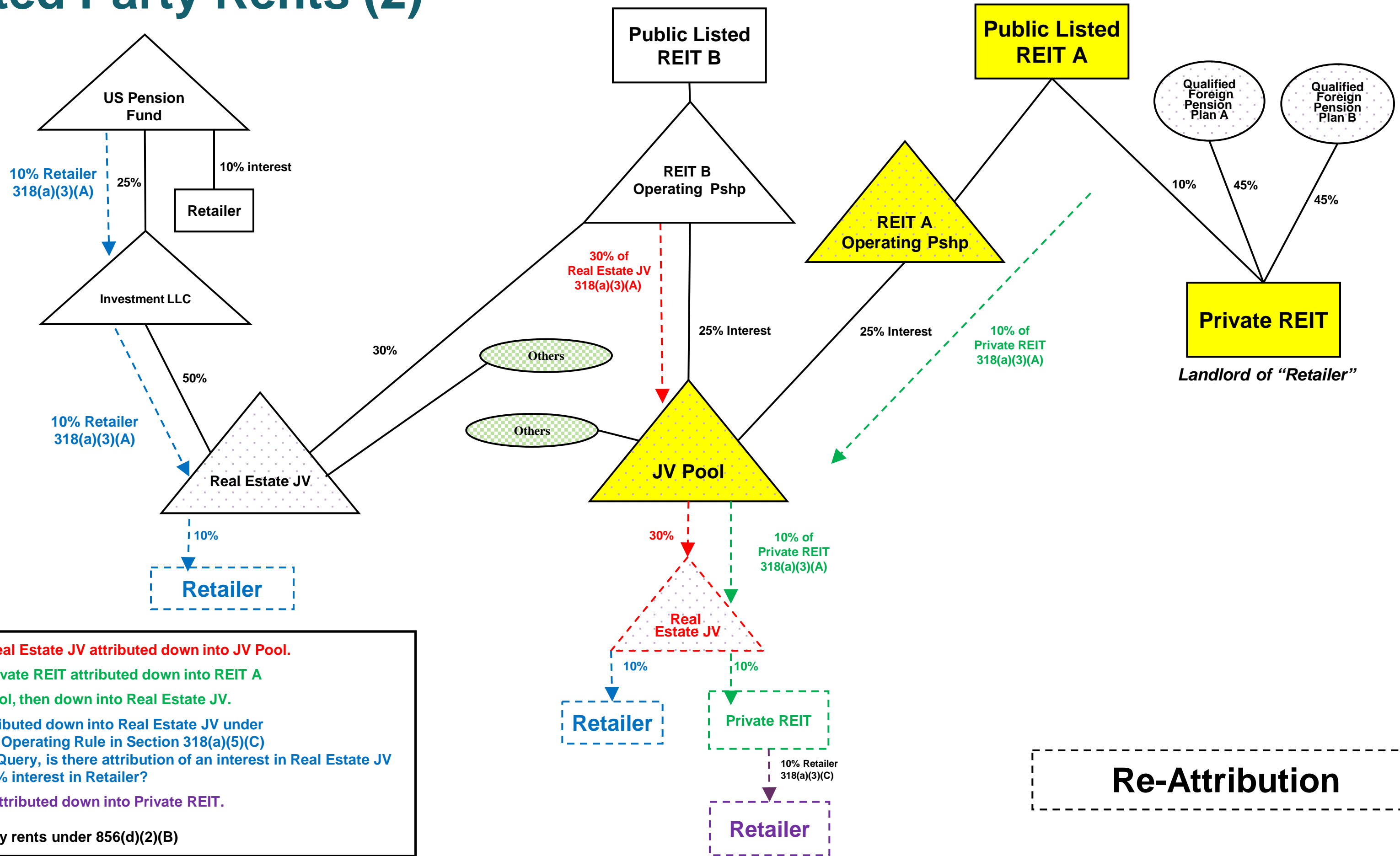


1. >10% interest in Tenant attributed down into Real Estate Partnership.
2. 15% interest in Private REIT C attributed down into Real Estate Partnership.
3. 45% interest in Private REIT E attributed down into Private REIT C under Real Estate Partnership. Should the Operating Rule in Section 318(a)(5)(C) prevent this result. Query, is there attribution of an interest in Private REIT E by attribution of Private REIT C?
4. If Tenant (10%) attributed down into Private REIT C, then down into Private REIT E as well.

Result: Related party rents under 856(d)(2)(B)

- If Tenant leases space from Private REIT C or Private REIT E, the rent may be non-qualifying income under IRC 856(d)(2)(B) by application of the IRC 318 attribution rules.
- This non-qualifying income will likely cause a failure of the REIT gross income tests for the Private REITs if they own only a single small property.
- A loss of REIT status for Private REIT C or Private REIT E could result in a REIT asset test violation for Public Listed REIT A and Public Listed REIT D.

Related Party Rents (2)



1. 30% interest in Real Estate JV attributed down into JV Pool.
2. 10% interest in Private REIT attributed down into REIT A OP, down into JV Pool, then down into Real Estate JV.
3. Retailer (10%) attributed down into Real Estate JV under JV Pool. Should the Operating Rule in Section 318(a)(5)(C) prevent this result. Query, is there attribution of an interest in Real Estate JV together with the 10% interest in Retailer?
4. Is Retailer (10%) attributed down into Private REIT.

Result: Related party rents under 856(d)(2)(B)

Revenue Ruling 74-605

(Deals with an upstream stock sale and the inapplicability of § 304(a))

Reg. § 1.318-1(b)(1) provides that a corporation will not be considered to own its own stock by reason of § 1.318 (a)(3)(C) (attribution from its shareholders)

Corp X (U.S.)

100%

Corp Y (U.S.)

100%

Corp Z (U.S.)

100%

Corp S (U.S.)

Applying 318(a), X would be treated as owning Z and Z would be treated as owning Y, and Z would be treated as owning the stock owned by Y, which would include its own stock but for the operation of Reg. § 1.318-1(b)(1)

Appendix
Pertinent Provisions of IRC § 318(a), as Modified

For purposes of determining whether a person is a related tenant or an independent contractor, the rules prescribed in section 318(a) apply, with specific modifications, to determine the ownership of the stock, assets, or net profits of any person. As modified,

- Section 318(a)(2)(A) provides that stock, assets, and net profits interests owned by a partnership are considered to be owned proportionately by its partners.
- Section 318(a)(3)(A) provides that stock, assets, and net profits interests owned by a partner that owns (directly or indirectly) a 25-percent-or-more interest in the capital of profits of a partnership are considered to be owned by the partnership.
- Section 318(a)(2)(C) provides that if 10 percent or more in value of the stock in a corporation is owned, directly or indirectly, by any person, such person is considered as owning the stock, assets, and net profits interests owned by that corporation in the proportion that the value of the stock that the person owns bears to the value of all the stock of the corporation.

Pertinent Provisions of IRC § 318(a), as Modified *(cont'd)*

- Section 318(a)(3)(C) provides that if 10 percent or more in value of the stock of a corporation is owned, directly or indirectly, by any person, the corporation is treated as owning the stock, assets, and net profits interests owned by that person.
- Under section 318(a)(5)(A), stock owned constructively owned by a person due to the application of the 318(a) of the Section Rules shall for purposes of such Rules be treated as owned by such person (except as provided in sections 318(a)(5)(B) and (C)).
- Under section 318(a)(5)(C), stock, assets, and net profits interests constructively owned by a partnership or corporation pursuant to section 318(a)(3) will not be considered as owned by the partnership or corporation for purposes of applying section 318(a)(2) to make another person the constructive owner of the stock, assets, or net profits interests.

Intangible – Above Market Leases

General Rule Under Treas. Reg. § 1.856-10(f)(1):

To the extent that an intangible asset, including an intangible asset established under generally accepted accounting principles (GAAP) as a result of an acquisition of real property or an interest in real property, derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space, the intangible asset is real property or an interest in real property.

Intangible Assets – Requirements

Three Requirements for Treating an Intangible Asset as an Interest in Real Property:

- The intangible asset derives its value from real property or an interest in real property
- The intangible asset is inseparable from real property or an interest in real property
- The intangible asset does not produce or contribute to the production of income other than consideration for the use or occupancy of space

Above Market Lease – Example

- **Example 11 under Treas. Reg. § 1.856-10(g)**

REIT K acquires an office building from an unrelated third party subject to a long-term lease with a single tenant under which the tenant pays above-market rents. The above-market lease is an intangible asset under GAAP. Seventy percent of the value of the above-market lease asset is attributable to income from the long-term lease that qualifies as rents from real property, as defined in section 856(d)(1). The remaining thirty percent of the value of the above-market lease asset is attributable to income from the long-term lease that does not qualify as rents from real property. The portion of the value of the above-market lease asset that is attributable to rents from real property (here, seventy percent) derives its value from real property, is inseparable from that real property, does not produce or contribute to the production of income other than consideration for the use or occupancy of space, and, therefore, is an interest in real property under section 856(c)(5)(C) and a real estate asset under section 856(c)(5)(B). The remaining portion of the above-market lease asset does not derive its value from real property and, therefore, is not a real estate asset.

[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

DECEMBER 17, 1997

JCS–23–97

Reasons for Change

The rule leaving open the partnership taxable year with respect to a deceased partner was adopted in 1954 to prevent the bunching of income that could occur with respect to a partnership reporting on a fiscal year other than the calendar year. Without this rule, as many as 23 months of income might have been reported on the partner's final return. Legislative changes occurring since 1954 have required most partnerships to adopt a calendar year, reducing the possibility of bunching. Consequently, income and deductions are better matched if the partnership taxable year closes upon a partner's death and partnership items are reported on the decedent's last return.

Prior law closed the partnership taxable year with respect to a deceased partner only if the partner's entire interest is sold or exchanged pursuant to an agreement existing at the time of death. By closing the taxable year automatically upon death, the provision reduces the need for such agreements.

Explanation of Provision

The provision provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise. The provision does not change prior law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

Effective Date

The provision applies to partnership taxable years beginning after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 per year in each of 1998 through 2007.

D. Modifications of Rules for Real Estate Investment Trusts (secs. 1251–1263 of the Act and secs. 856 and 857 of the Code)

Present and Prior Law

Overview

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT generally is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property.

Election to be treated as a REIT

In order to qualify as a REIT, and thereby receive conduit treatment, an entity must elect REIT status. A newly-electing entity generally cannot have earnings and profits accumulated from any year in which the entity was in existence and not treated as a REIT (sec. 857(a)(3)). To satisfy this requirement, the entity must distribute, during its first REIT taxable year, any earnings and profits that were accumulated in non-REIT years. For this purpose, under prior law, distributions by the entity generally are treated as being made from the most recently accumulated earnings and profits.

Taxation of REITs

Overview

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts (sec. 857). REITTI is the taxable income of the REIT with certain adjustments (sec. 857(b)(2)). The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes.

Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the capital gains tax regime generally applicable to corporations (sec. 857(b)(3)). However, a REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders (sec. 857(b)(3)(C)). A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of the holding period of their stock (sec. 857(b)(3)(C)).

A regulated investment company ("RIC"), but not a REIT, may elect to retain and pay income tax on net long-term capital gains it received during the tax year. If a RIC makes this election, the RIC shareholders must include in their income as long-term capital gains their proportionate share of these undistributed long-term capital gains as designated by the RIC. The shareholder is deemed to have paid the shareholder's share of the tax, which can be credited or refunded to the shareholder. Also, the basis of the shareholder's shares is increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the RIC) included in the shareholder's long-term capital gains.

Income from foreclosure property

In addition to tax on its REITTI, a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property (sec. 857(b)(4)). Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or

business and gross income from foreclosure property (other than income that otherwise would qualify under the 75-percent income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property) such property was not held by the REIT for sale to customers (sec. 856(e)). Under prior law, a property generally may be treated as foreclosure property for a period of two years after the date the property is acquired by the REIT. The IRS may grant extensions of the period for treating the property as foreclosure property if the REIT establishes that an extension of the grace period is necessary for the orderly liquidation of the REIT's interest in the property. The grace period cannot be extended beyond six years from the date the property is acquired by the REIT.

Property will cease to be treated as foreclosure property if, after 90 days after the date of acquisition, the REIT operates the foreclosure property in a trade or business other than through an independent contractor from whom the REIT does not derive or receive any income (sec. 856(e)(4)(C)).

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. Accordingly, in addition to the tax on its REITTI and on its net income from foreclosure property, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions" (sec. 857(b)(6)). A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. A safe harbor is provided for certain sales that otherwise might be considered prohibited transactions (sec. 857(b)(6)(C)). The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year.

Requirements for REIT status

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, sub-

stantially all of the entity's income must be passed through to its shareholders on a current basis.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (sec. 856(a)). The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. Under prior law, a REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares. Treasury regulations require that the entity request information from certain shareholders regarding shares directly or indirectly owned by them.

Income requirements

Overview

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent test"), including rents from real property.

In addition, under prior law, less than 30 percent of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than one year, real property held less than four years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of sec. 1033), and property that is sold or disposed of in a prohibited transaction (sec. 856(c)(4)).

Definition of rents from real property

For purposes of the income requirements, rents from real property generally include: (1) rents from interests in real property; (2) charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated; and (3) rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease (sec. 856(d)(1)).

Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the col-

lection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. sec. 1.856–4(b)).

Exclusion of rents from related tenants

Amounts are not treated as qualified rent if they are received from corporate or noncorporate tenants in which the REIT, directly or indirectly, has an ownership interest of 10 percent or more (sec. 856(d)(2)(B)).

Exclusion of rents where services to tenants are performed by related contractors

Where a REIT furnishes or renders services to the tenants, amounts received or accrued with respect to such property generally are not treated as qualifying rents unless the services are furnished through an independent contractor (sec. 856(d)(2)(C)). A REIT may furnish or render a service directly, however, if the service would not generate unrelated business taxable income under section 512(b)(3) if provided by an organization described in section 511(a)(2). In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT (sec. 856(d)(3)(A)), and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT (sec. 856(d)(3)(B)).

Constructive ownership rules involving corporations

For purposes of determining the REIT's ownership interest in a tenant and whether a contractor is independent, the attribution rules of section 318 apply, except that 10 percent is substituted for 50 percent where it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3) (sec. 856(d)(5)). Thus, under section 318(a)(2)(C) (as so modified), if 10 or more percent of a REIT or other corporation is owned, directly or indirectly, by or for a person, that person is treated as owning that person's proportionate share of any stock owned directly or indirectly by that corporation.

Constructive ownership rules involving partnerships

Under section 318, stock owned, directly or indirectly, by or for a partnership is considered owned proportionately by its partners (sec. 318(a)(2)(A)). In addition, stock owned, directly or indirectly, by or for a partner is considered owned by the partnership (sec. 318(a)(3)(A)). However, stock constructively owned by a partnership is not considered as owned for purposes of being constructively owned by partners (sec. 318(a)(5)(C)). The following examples illustrate the application of these provisions for purposes of the related tenant and independent contractor rules.

Constructive ownership of tenant

If a REIT owns a 10 percent or greater interest in a person that is a tenant of the REIT, rents paid by that person to the REIT are not qualifying rents to the REIT (sec. 856(d)(2)(B)).

Example 1—If 10 percent or more of a REIT's shares are owned by a partnership and a partner owning a one-percent interest in that partnership also owns a 10-percent or greater interest in a person that is a tenant of the REIT, rents paid by the tenant to the REIT are not qualifying rents to the REIT; the 10-percent or greater interest in the tenant is considered owned by the partnership (sec. 318(a)(3)(A)) and in turn by the REIT (secs. 318(a)(3)(C) and 856(d)(5)).

Example 2—If a REIT owns a 30-percent interest in a partnership that in turn owns a 40-percent interest in a person that is a tenant of the REIT, rents paid by that person to the REIT are not qualifying rents to the REIT because the REIT is considered to own more than 10 percent of the tenant (sec. 318(a)(2)(A)).

Example 3—If 10 percent or more of a REIT's shares are owned by persons who are 50-percent partners in a partnership whose other partners own the entirety of the interests in a tenant of the REIT, none of the interests in the tenant are considered owned by the partners who own interests in the REIT (sec. 318(a)(5)(C)).

Constructive ownership of contractor

If a person providing services to tenants of the REIT owns a greater-than-35-percent interest in the REIT, or if another person owns a greater-than-35-percent interest in both the REIT and a person providing services, amounts received or accrued by the REIT with respect to the property are not qualifying rents because the service provider does not qualify as an independent contractor (sec. 856(d)(3)).

Example 4—If more than 35 percent of a REIT's shares are owned by a partnership and a partner owning a one-percent interest in that partnership also owns a greater-than-35-percent interest in a contractor, that person will not be considered an independent contractor because the partnership owns more than 35 percent of the REIT's shares and will also be considered to own a greater-than-35-percent interest in the contractor (sec. 318(a)(3)A)).

Example 5—If more than 35 percent of a REIT's shares are owned by a person who owns a one-percent interest in a partnership and another one-percent partner in that partnership owns more than 35 percent of the interests in a contractor, the independent contractor definition will not be met because the partnership will be considered to own more than 35 percent interests in both the REIT and the contractor (sec. 318 (a)(3)(A)).

Hedging instruments

Interest rate swaps or cap agreements that protect a REIT from interest rate fluctuations on variable rate debt incurred to acquire or carry real property are treated as securities under the 30-percent test and payments under these agreements are treated as qualifying under the 95-percent test (sec. 856(c)(6)(G)).

Treatment of shared appreciation mortgages

For purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, any income derived from a "shared appreciation provision" is treated as gain recognized on the sale of the "secured property." For

these purposes, a shared appreciation provision is any provision that is in connection with an obligation that is held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as property described in section 1221(1) if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT). For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (sec. 856(c)(5)(A)). Moreover, not more than 25 percent of the value of the entity's assets can be invested in securities of any one issuer (other than government securities and other securities described in the preceding sentence). Further, these securities may not comprise more than five percent of the entity's assets or more than 10 percent of the outstanding voting securities of such issuer (sec. 856(c)(5)(B)). The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs (sec. 856(c)(6)(B)).

REIT subsidiaries

Under present law, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100 percent of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiary's stock, or ceased to be a REIT as the case may be.

Distribution requirements

To satisfy the distribution requirement, a REIT must distribute as dividends to its shareholders during the taxable year an amount equal to or exceeding (i) the sum of 95 percent of its REITTI other than net capital gain income and 95 percent of the excess of its net income from foreclosure property over the tax imposed on that income minus (ii) certain excess noncash income. Excess noncash items include (1) the excess of the amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting, (2) in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to a loan to which section 1274 applies, over the amount of money and fair market value of other property received with respect to the loan, and (3) income arising from the disposition of a real estate asset in certain transactions that failed to qualify as like-kind exchanges under section 1031.

Explanation of Provisions

Overview

The Act modifies many of the provisions relating to the requirements for qualification as, and the taxation of, a REIT. In particular, the modifications relate to the general requirements for qualification as a REIT, the taxation of a REIT, the income requirements for qualification as a REIT, and certain other provisions.

Alterative penalty for failure to make requests of shareholders (sec. 1251 of the Act)

The Act replaces the rule that disqualifies a REIT for any year in which the REIT failed to comply with Treasury regulations to ascertain its ownership, with an intermediate penalty for failing to do so. The penalty is $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also is required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the Treasury regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, is treated as meeting the requirement that it not be a personal holding company.

De minimis rule for tenant service income (sec. 1252 of the Act)

The Act permits a REIT to render a *de minimis* amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rent. The value of the impermissible services may not exceed one percent of the gross income from the property. For these purposes, the services may not be valued at less than 150 percent of the REIT's direct cost of the services.

Attribution rules applicable to tenant ownership (sec. 1253 of the Act)

The Act modifies the application of the rule attributing ownership from partners to partnerships (sec. 318(a)(3)(A)) for purposes of defining non-qualifying rent from related persons (sec. 856(d)(2)), so that attribution occurs only when a partner owns directly or indirectly a 25-percent or greater interest in the partnership. Thus, a REIT and a tenant will not be treated as related (and, therefore, rents paid by the tenant to the REIT will not be treated as non-qualifying rents) if the REIT's shares are owned by a partnership and a partner owning a directly and indirectly less-than-25-percent interest in that partnership also owns an interest in the tenant. The related tenant rule (sec. 856(d)(2)(B)) also will not be violated where owners of the REIT and owners of the tenant are partners in a partnership and either the owners of the REIT or the owners of the tenant are directly and indirectly less-than-25-percent partners in the partnership.

In addition, the Act extends, to the definition of an independent contractor under section 856(d)(3), the modification to the attribution to partnerships of section 318(a)(3)(A) so that attribution occurs only when a partner owns a 25-percent or greater interest in the partnership. Thus, a person providing services will not fail to be an independent contractor (and, therefore, amounts received or accrued by the REIT with respect to the property will not be treated as non-qualifying rents) where the REIT's shares are owned by a partnership and a partner owning a directly and indirectly a less-than-25-percent interest in the partnership also owns an interest in a contractor. Similarly, a contractor will not fail to be an independent contractor where owners of the REIT and owners of the contractor are partners in a partnership and either the owners of the REIT or owners of the tenant are directly and indirectly less-than-25-percent partners in the partnership.

Credit for tax paid by REIT on retained capital gains (sec. 1254 of the Act)

The Act permits a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted under present law. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would be deemed to have paid the shareholder's share of the tax, which would be credited or refunded to the shareholder. Also, the basis of the shareholder's shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains.

Repeal of 30-percent gross income requirement (sec. 1255 of the Act)

The Act repeals the rule that requires less than 30 percent of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than one year, certain

real property held less than four years, and property that is sold or disposed of in a prohibited transaction.

Modification of earnings and profits for determining whether REIT has earnings and profits from non-REIT year (sec. 1256 of the Act)

The Act changes the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years. Under the Act, distributions of accumulated earnings and profits generally are treated as made from the entity's earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits. These distributions are not treated as distributions for purposes of calculating the dividends paid deduction.

Treatment of foreclosure property (sec. 1257 of the Act)

The Act lengthens the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also can be extended for an additional three years by filing a request to the IRS. A REIT can revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before its due date for filing its tax return.

In addition, the Act conforms the definition of independent contractor for purposes of the foreclosure property rule (sec. 856(e)(4)(C)) to the definition of independent contractor for purposes of the general rules (sec. 856(d)(2)(C)).

Payments under hedging instruments (sec. 1258 of the Act)

The Act treats income from all hedges that reduce the interest rate risk of REIT liabilities, not just from interest rate swaps and caps, as qualifying income under the 95-percent test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) are treated as qualifying income for purposes of the 95-percent test.

Excess noncash income (sec. 1259 of the Act)

The Act (1) expands the class of excess noncash items that are not subject to the distribution requirement to include income from the cancellation of indebtedness and (2) extends the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.

Prohibited transaction safe harbor (sec. 1260 of the Act)

The Act excludes from the prohibited sales rules property that was involuntarily converted.

Shared appreciation mortgages (sec. 1261 of the Act)

The Act provides that interest received on a shared appreciation mortgage is not subject to the tax on prohibited transactions where the property subject to the mortgage is sold within four years of the

REIT's acquisition of the mortgage pursuant to a bankruptcy plan of the mortgagor unless the REIT acquired the mortgage knew or had reason to know that the property subject to the mortgage would be sold in a bankruptcy proceeding.

Wholly-owned REIT subsidiaries (sec. 1262 of the Act)

The Act permits any corporation wholly-owned by a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. Where the REIT acquired an existing corporation, any such corporation is treated as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the normal rules of sec. 337). In addition, any pre-REIT earnings and profits of the subsidiary must be distributed before the end of the REIT's taxable year.

Effective Date

The provisions are effective for taxable years beginning after the date of enactment (August 5, 1997).

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $4 million in 1998, $5 million in both 1999 and 2000, $6 million in 2001, $7 million in both 2002 and 2003, $8 million in 2004, $9 million in 2005, $10 million in 2006, and $11 million in 2007.

E. Repeal of the 30-percent ("Short-Short") Test for Regulated Investment Companies (sec. 1271 of the Act and sec. 851(b)(3) of the Code)

Present and Prior Law

A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. The Code provides conduit treatment by permitting a RIC to deduct dividends paid to its shareholders in computing its taxable income. In order to qualify for conduit treatment, the RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)). In addition, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). In particular, under prior law, a corporation must derive less than 30 percent of its gross income from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held less than three months (the "short-short test") (sec. 851(b)(3)).

Reasons for Change

The short-short test restricts the investment flexibility of RICs. The test can, for example, limit a RIC's ability to "hedge" its investments (e.g., to use options to protect against adverse market moves).

Rep Shaws Introductory Remarks on REITSA

REAL ESTATE INVESTMENT TRUST SIMPLIFICATION ACT OF 1997 ("REITSA")

Rep. Shaw's Introductory Remarks on REITSA
Excerpted from 143 Cong. Rec. E559 (Daily ed. March 21, 1997)

MR. SHAW: Mr. Speaker, today I am introducing H.R. 1150, the Real Estate Investment Trust Simplification Act of 1997 ("REITSA"), a bill to amend portions of the Internal Revenue Code dealing with real estate investment trusts, or REITs. The legislation responds to the need for simplification in the regulation of the day-to-day operation of REITs. REITSA is co-sponsored by Mr. Matsui, Mr. Crane, Mr. Thomas, Mrs. Johnson, Mr. Houghton, Mr. Herger, Mr. McCrery, Mr. Camp, Mr. Johnson, Ms. Dunn, Mr. Collins, Mr. English, Mr. Ensign, Mr. Weller, Mr. Stark, Mr. Levin and Mr. Cardin. The Joint Committee on Taxation has determined that REITSA has a negligible effect on Federal fiscal year budget receipts. In 1960, Congress created REITs to function as the real estate equivalent of the regulated investment company, or mutual fund. As such, they permit small investors to participate in real estate projects that the investors could not undertake individually and with the assistance of experienced management. Over time, the REIT industry has matured into its intended role with the greatest strides made in this decade. This development of the REIT industry is a result of a number of factors. As important as any other were the changes Congress enacted in 1986 to the REIT rules themselves and the tax landscape in general. With respect to the general provisions, throughout the 1980s limited partnerships used the offer of multiple dollars of tax paper losses for each invested dollar to attract investors away from solid investments like REITs, which seek to provide investors with consistent distributions from economically feasible real estate investments but provide no opportunity to receive a pass-through of tax motivated losses. Accordingly, the elimination of those tax loss loopholes led investors to look for income-producing investment opportunities. Also included in the 1986 tax legislation were important modifications to the REIT provisions of the Code. Among the changes made as part of that modernization of the REIT tax laws (the first in a decade and the most recent comprehensive revision of the REIT laws), the most significant was the change allowing REITs to directly provide to tenants those services customary in the leasing of real estate as had been permitted to pension plans and other tax-exempt entities engaged in the leasing of real property. Prior to that change, a REIT was required to use an independent contractor to provide those services. These legislative changes and the lack of credit to recapitalize America's real estate produced a suitable environment for the substantial growth in the REIT industry and the fulfillment of Congress' original hopes for the REIT vehicle. From 1990 to present, the industry has grown from a market capitalization of approximately $9 billion to nearly $100 billion. Fueling that growth has been the introduction of some of America's leading real estate companies to the family of long existing, viable REITs. As a result, the majority of today's REITs are owners of quality, income-producing real estate. Thus, hundreds of thousands of individuals that own REIT shares through direct investment (plus the many more who are interest holders in the growing number of mutual funds or pension funds investing in REITs) have become participants in the recapitalization of tens of billions of dollars of America's best real estate investments. Likewise, investors in mortgage REITs have the opportunity to participate in the ever growing market for securitized mortgages, further contributing to the recapitalization of quality real estate. The benefits of the growth in the REIT industry were addressed in a 1995 Urban Land Institute White Paper titled The REIT Renaissance. That White Paper concluded that "[f]rom an overall economic standpoint, the real estate industry and the economy should be well served by the expansion of the REIT industry-- the broadening of participation in real estate ownership, the investment in market information and research that the public market will bring, and the more timely responsiveness to market signals that will result from better information and market analysis."

To assist the continued growth of this important industry, H.R. 1150 was developed to address areas in the existing tax regime that present significant, yet unnecessary, barriers to the use of the REIT vehicle. The proposals represent a modernization of the most complex parts of the regulatory structure under which REITs operate, while leaving intact the basic underlying ownership, income, asset, and distribution tests introduced in the original REIT legislation. The proposals are supported by the National Association of Real Estate Investment Trusts, the National Realty Committee, the International Council of Shopping Centers, the National Multi-Housing Council, the Building Owners and Managers Association International, the National Association of Industrial & Office Properties and other national organizations.

SUMMARY OF KEY PROVISIONS OF H.R. 1150
A. Title I contains three proposals to remove unnecessary "traps for the unwary." These proposals would address current requirements that are not necessary to satisfy Congressional objectives, that carry a disproportionate penalty for even unintentional oversights, or that are impracticable in today's environment. Title I's overriding intention is not to penalize a REIT's many small investors by stripping the REIT of its tax status as a result of an act that does not violate Congress' underlying intent in creating the REIT vehicle.

Section 101. Shareholder Demand Letter.

The potential disqualification for a REIT's failure to send shareholder demand letters should be replaced with a reporting penalty. Under present law, regulations require that a REIT send letters to certain shareholders within 30 days of the close of the REIT's taxable year. The letters demand from its shareholders of record, a written statement identifying the "actual owner" of the stock. A REIT's failure to comply with the notification requirement may result in a loss of REIT status. The failure to send so-called demand letters may result in the disqualification of a REIT with thousands of shareholders that easily satisfies the substantive test because of a purely technical violation. As a result of disqualification, a REIT would be compelled to pay taxes for all open years, thereby depriving their shareholders of income generated in compliance with all of the REIT rules. Fortunately, the Internal Revenue Service has not enforced any such technical disqualifications and instead has entered into closing agreements with several REITs. The proposal would alleviate the need to enter into such closing agreements on a prospective basis.

H.R. 1150 provides that a REIT's failure to comply with the demand letter regulations would not, by itself, disqualify a REIT if it otherwise establishes that it satisfies the substantive "five or fewer" ownership rules. But under these circumstances, a $25,000 penalty ($50,000 for intentional violations) would be imposed for any year in which the REIT did not comply with the shareholder demand regulations and the REIT would be required, when requested by the IRS, to send curative demand letters or face an additional penalty equal to the amounts related above. In addition, to protect a REIT that meets the regulations, but is otherwise unable to discover the actual ownership of its shares, the bill provides that a REIT would be deemed to satisfy the "five or fewer" share ownership rules if it complies with the demand letter regulations and does not know, or have reason to know, of an actual violation of the ownership rules.

Section 102. De Minimus Rule for Tenant Services Income.

The uncertainty related to qualifying services for a REIT should be addressed by a reasonable de minimus test. In 1986, Congress modernized the REITs' independent contractor rules to allow them to directly furnish to tenants those services customary in the management of rental property. However, certain problems persist. Under existing law, a REIT's receipt of any amount of revenue as a result of providing an impermissible service to tenants with respect to a property may disqualify all rents received with respect to that property. For example, if a REIT's employee assists a tenant in moving in or out of an apartment complex (a potentially impermissible service), technically the IRS could contend that all the income from the apartment complex is disqualified, even though the REIT received no direct revenue for the provided service. The disqualification of a large property's rent could seriously threaten, or even terminate, the REIT's qualified status. Interestingly, at the same time a REIT could be severely punished for providing services to tenants or their visitors, the REIT rules properly provide that up to 5% of a REIT's gross income may come from providing services to non-tenants. Thus, under present law a REIT is better off providing services to nontenants than providing the same services to tenants. In addition to the potential disqualification of rents, the absence of a de minimus rule requires the REIT to spend significant time and energy in monitoring every action of its employees, and significant dollars in attorney fees to determine whether each potential action is an impermissible service. The uncertainty regarding the permissibility of services also requires the IRS to expend considerable resources in responding to private ruling requests. To lessen the burden of monitoring each REIT employee's every action and to eliminate unnecessary disqualification of tenant rents, H.R. 1150 provides for a de minimus exception. The exception would treat small amounts of revenue resulting from an impermissible service in a manner similar to revenue received from providing services to non-tenants, and protect the classification of rents from the affected property as qualifying REIT income. The de minimus exception is equal to 1% of the gross income from the affected property. The de minimus exception is based on gross income to be consistent with the REIT's income tests, and is set at 1% to reflect an amount large enough to provide the requisite safe harbor (note that it is 1% of the income from an affected property, regardless how small, and not all properties owned by the REIT), yet small enough not to encourage disregard of the independent contractor rule. Because many of the services in question would not result in a direct receipt of gross income, the bill provides a mechanism for establishing the gross income received relative to an impermissible service. The gross income would be deemed at least equal to the direct costs of the service (i.e. labor, cost of goods) multiplied by 150%. For example, if the IRS determined that a REIT's providing wheelchairs at a mall is an impermissible service, the cost of the wheelchairs would be multiplied by 150% to achieve the gross income realized from the impermissible service. If that and any other gross income related to impermissible services provided to tenants of that mall does not exceed 1% of the malls gross income for the year, the impermissible service income would be classified as non-qualifying income. However, rents received from tenants of the mall would not be disqualified.

A REIT's actions are still policed under this change. First, if a REIT's gross income from impermissible services exceeds 1% of the gross income from the affected property, that income and the rents from that property would be disqualified as under current law. Second, as previously noted, a REIT's gross income from non-qualifying sources is limited to 5% of total gross income. Accordingly, gross income from impermissible sources that does not exceed the 1% threshold would be included in that small basket, thereby placing a second check on the REIT's activities.

Section 103. Attribution Rules Applicable To Tenant Ownership.

Unintended double attribution under section 318 should be minimized, while preserving the intended purpose of the attribution rule. The attribution rules of section 318 are interjected to ensure that a REIT does not receive rents from a 10% or more related party, in which case the rents are deemed disqualified income for the REIT gross income tests. While the intention of that rule is proper, a quirk in the application of section 318 to REITs as called for under section 856(d)(2) may result in the disqualification of a REIT's rents when no actual direct or indirect relationship exists between the REIT and tenant. Under section 318(a)(3)(A), stock owned directly or indirectly, by a partner is considered owned by the partnership. In addition, under section 318(a)(3)(C), a corporation is considered as owning stock that is owned, directly or indirectly, by or for a person who also owns more than 10% (in the case of REITs) of the stock in such corporation. Those attribution rules may create an unintended result when several persons who collectively own 10% of a REIT's tenant, also own collectively 10% of the REIT. So long as those persons are unrelated, because their individual interests in both the REIT and tenant do not equal 10% the REIT is not deemed to own 10% of the tenant. However, if those persons obtain interests, regardless of how small, in the same partnership the REIT will be deemed to own 10% of the tenant. This results from the partnership's deemed ownership of the partners' stock in both tenant and the REIT. Further, because the partnership becomes a deemed 10% owner of the REIT under section 318(a)(3)(A), REIT is deemed the 10% owner of tenant under section 318(a)(3)(C). In essence, the REIT becomes the deemed 10% owner of its tenant as a result of a variation of the partner-to-partner attribution that section 318(a)(5)(C) specifically was enacted to prevent. It is only through the combination of the partners' various interests in the REIT and tenant that a disqualification of the rents occurs. This is true regardless of the purpose for the partnership's existence. The partners may have no knowledge of the other's existence and may be partners in a huge limited partnership completely unrelated to the REIT. H.R. 1150 addresses this problem by modifying the application of section 318(a)(3)(A) (attribution to the partnership) only for purposes of section 856(d)(2), so that attribution would occur only when a partner holds a 25% or greater interest in the partnership. This threshold presumes that such a partner would have knowledge of the other persons holding interests in the partnership, and would have an opportunity to determine if those persons hold an interest in the REIT. By not suspending the double attribution entirely, the bill prevents the potentially abusive practice of placing a "dummy" partnership between the REIT and those persons holding interests in the tenant.

B. Title II of REITSA contains two proposals that would assist in carrying out Congress' original intent to create a real estate vehicle analogous to regulated investment companies ("RICs").

Section 201. Credit For Tax Paid By REIT On Retained Capital Gains.

Current law taxes a REIT that retains capital gains, and imposes a second level of tax on the REIT shareholders when later they receive the capital gain distribution. H.R. 1150 provides for the REIT rules to be modified to correspond with the mutual fund rules governing the taxation of retained capital gains by passing through a credit to shareholders for capital gains taxes paid at the corporate (REIT) level. This modification is necessary to prevent the unintended depletion of a REIT's capital base when it sells property at a taxable gain. Accordingly, the REIT could acquire a replacement property without incurring costly charges associated with a stock offering or debt.

Section 202. Reduction in the 95% Distribution Requirement.

H.R. 1150 calls for reducing the REIT distribution requirement of taxable ordinary income from 95% to 90%. RICs have a similar distribution requirement, which is set at 90%. The REIT distribution requirement was 90% from 1960 until 1976. As part of the Tax Reform Act of 1976, REITs were granted a special "deficiency dividend procedure" designed to protect their status in the face of a redetermination of distributable income pursuant to an IRS audit. In exchange for this decreased risk of inadvertent disqualification, REITs were asked to distribute a higher percentage of their income. However, when the deficiency dividend procedure was extended to RICs in 1978, no corresponding change was made to the RIC distribution requirement. Accordingly, H.R. 1150 calls for a reduction in the REIT distribution requirement to restore conformity between REITs and RICs.

C. Title III of REITSA would simplify several technical problems that REITs face in their organization and day-to-day operations. Many of these proposals would build on simplifications that Congress has adopted over the years.

Section 301. Modification Of Earnings And Profits Rules For Determining Whether REIT Has Earnings And Profits From Non-REIT Year.

Only for purposes of the requirement that a REIT distribute all pre-REIT earnings and profits ("E & P") within its first taxable year as a REIT, a REIT's distributions should be deemed to carry out all pre-REIT earnings before shareholders are considered to be receiving REIT E & P. Under existing law, a REIT must not only distribute 95% of its REIT taxable income to shareholders, but it must in its first year distribute all pre-REIT year E & P. If the company mistakenly underestimates the amount of E & P generated while operating as a REIT it may fail to satisfy those requirements because the ordering rules controlling the distribution of E & P currently provide that distributions first carry out the most recently accumulated E & P. Thus, if a REIT distributes the pre-REIT E & P and the expected REIT E & P in its first REIT taxable year, the year-end receipt of any unanticipated income would result in the reclassification of a portion of the distribution intended to pass out the pre-REIT E & P.

While REITs have methods available to make distributions after the close of their taxable year that relate back to assure satisfaction of the 95% income distribution requirement (to be changed to 90% under REITSA), those methods can not be used to cure a failure to distribute pre-REIT E & P after the close of the REIT's taxable year. Accordingly, by allowing the REIT's distributions to first carry out the pre-REIT E & P, the REIT could satisfy both distribution requirements by using one of the deferred distribution methods to distributed the unanticipated income discussed in the example.

Section 302. Treatment Of Foreclosure Property.

Rules related to foreclosure property should be modernized. For property acquired through foreclosure on a loan or default on a lease, under present law a REIT can elect foreclosure property treatment. That election provides the REIT with 3 special conditions to assist it in taking over the property and seeking its re-leasing or sale. First, a REIT is permitted to conduct a trade or business using property acquired through foreclosure for 90 days after it acquires such property, provided the REIT makes a foreclosure property election. After the 90-day period, the REIT must use an independent contractor to conduct the trade or business (a party from whom the REIT does not receive income). Second, a REIT may hold foreclosure property for resale to customers without being subject to the 100% prohibited transaction tax (although subject to the highest corporate taxes). Third, non-qualifying income from foreclosure property (from activities conducted by the REIT or independent contractor after 90 days) is not considered for purposes of the REIT gross income tests, but generally is subject to the highest corporate tax rate. The foreclosure property election is valid for 2 years, but may be extended for 2 additional terms (a total of 6 years) with IRS consent. Under H.R. 1150, the election procedure would be modified in the following ways: (1) the initial election and one renewal period would last for 3 years; (2) the initial election would remain effective until the last day of the third taxable year following the election (instead of exactly two years from the date of election); and (3) a one-time election out of foreclosure property status would be made available to accommodate situations when a REIT desires to discontinue foreclosure property status.

In addition, the independent contractor rule under the election would be modernized so that it worked in the same manner as the general independent contractor rule. Currently, a REIT may provide to tenants of non-foreclosure property services customary in the leasing of real property. However, this previous modernization of the independent contractor rule was not made to the rules governing the required use of independent contractors for foreclosure property.

Section 303. Special Foreclosure Rules For Health Care Properties.

In the case of health care REITs, H.R. 1150 provides that a REIT would not violate the independent contractor requirement if the REIT receives rents from a lease to that independent contractor as a tenant at a second health care facility. This change recognizes the limited number of health care providers available to serve as an independent contractor on a property acquired by the REIT in foreclosure, and the REIT's likely inability to simply close the facility due to the nature of the facility's inhabitants.

In addition, the health care rules would extend the foreclosure property rules to expirations or terminations of health care REIT leases, since similar issues concerning a limited number of operators arise in those circumstances. However, foreclosure property treatment in these cases would be limited to a two-year period, unless the Secretary grants one or two possible two-year extensions.

Section 304. Payments Under Hedging Instruments.

H.R. 1150 would extend the REIT variable interest hedging rule to permit a REIT to treat as qualifying any income from the hedge of any REIT liability secured by real property or used to acquire or improve real property. For example, this provision would apply to hedging a REIT's unsecured corporate debenture or the currency risk of a debt offering denominated in a foreign currency.

Section 305. Excess Noncash Income.

H.R. 1150 would expand the use of the excess noncash income exclusion currently provided under the REIT distribution rules. The bill would (1) extend the exclusion to include most forms of phantom income and (2) make the exclusion available to accrual basis REITs. Under the exclusion, listed forms of phantom income would be excluded from the REIT 90% distribution requirement. However, the income would be taxed at the REIT level if the REIT did not make sufficient distributions. **Section 306. Prohibited Transaction Safe Harbor.** H.R. 1150 would correct a problem in the wording of Congress' past liberalization of the safe harbor from the 100% excise tax on prohibited transactions, i.e., sales of property in the ordinary course of business. Involuntary conversions of property no longer would count against the permitted 7 sales of property under the safe harbor. **Section 307. Shared Appreciation Mortgages ("SAM").** In general, section 856(j) provides that a REIT may receive income based on a borrower's sale of the underlying property. However, the character of that income is determined by the borrower's actions. The SAM provision would be modified and clarified so that a REIT lender would not be penalized by a borrower's bankruptcy (an event beyond its control) and would clarify that a SAM could be based on appreciation in value as well as gain. **Section 308. Wholly Owned Subsidiaries.** In 1986, Congress realized the usefulness of a REIT holding properties in subsidiaries to limit its liability exposure. H.R. 1150 would codify an IRS private letter ruling position providing that a REIT may treat a wholly-owned subsidiary as a qualified REIT subsidiary even if the subsidiary previously had been owned by a non-REIT entity. H.R. 1150 would allow a REIT to treat a corporation as a qualified REIT subsidiary when it acquires for cash and/or stock all the stock of a non-REIT C or S corporation. The effective date would be for taxable years beginning after the date of enactment.