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Congress Enacts New Laws Affecting REITs

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On July 30, 2008, President Bush signed into law H.R. 3221, the American Housing Rescue and Foreclosure Prevention Act of 2008 (the "Act"), significantly revamping certain rules related to real estate investment trusts ("REITs"). A REIT is an entity that is otherwise subject to tax as a U.S. corporation, but has elected to be taxed under a preferential regime in which dividends distributed to REIT shareholders are generally tax-deductible by the REIT. In effect, a REIT escapes the double-tax system applicable to corporations and REIT income is taxed only at the investor level. The Act clarifies certain rules for REIT qualification, increases the permissible size of REIT investments in taxable REIT subsidiaries and relaxes the REIT safe harbor for dealer sales. The following provides a brief summary of the REIT provisions under the Act.

Excluding Certain Foreign Currency Gains from REIT Income Test

In order to qualify as a REIT for a taxable year, at least 75% of an entity's annual gross income must be derived from certain real estate-related items including real property rents, mortgage interest, gain from disposition of non-dealer real property and shares in other REITs (the "75% Income Test") and 95% of such entity's annual gross income must be derived from items meeting the 75% Income Test or from an additional category of passive income including dividends, interest, and gains from disposition of non-dealer stock or securities (the "95% Income Test," together with the 75% Income Test, the "Income Tests").[1] In the wake of a weakening U.S. dollar, REITs have increasingly begun to invest in assets denominated in a currency other than the U.S. dollar. A REIT's business or investment activity using a currency other than the U.S. dollar may generate foreign currency gain under Code Section 987 or 988. As a result, tax practitioners have questioned whether a REIT's foreign currency gain derived from its passive or foreign real estate investments constitutes qualifying income under the Income Tests. Although not explicitly specified as qualifying income under Code Section 856, recently issued Internal Revenue Service ("IRS") guidance has treated such income as qualifying income.[2]

Under the Act, certain foreign currency gain may be excluded from gross income for purposes of the Income Tests. Specifically, the Act defines two new categories of income under the Income Tests: real estate foreign exchange gain ("RE FX Gain") and passive foreign exchange gain ("Passive FX Gain"). In general, RE FX Gain is foreign currency gain derived from real estate related items. The Act defines RE FX Gain as foreign currency gain attributable to: (i) income items qualifying under the 75% Income Test (e.g., rents); (ii) the acquisition or ownership of mortgages; or (iii) becoming the obligor on an obligation secured by mortgages or real property. RE FX Gain also includes foreign currency gain of a REIT's foreign branch (i.e., a "qualified business unit"), but only if the branch itself meets the 75% Income Test for the taxable year and meets the 75% Asset Test (as defined below) at the close of each quarter. Passive FX Gain generally includes all RE FX Gain plus foreign currency gain derived from passive investments. The Act defines Passive FX Gain as foreign currency gain attributable to: (i) any item of income or gain qualifying under the 95% Income Test; (ii) the acquisition or ownership of obligations; or (iii) becoming or being the obligor on obligations. Lastly, RE FX Gain and Passive FX Gain will also include any foreign currency gain determined by the Secretary of the Treasury to be includible in either definition.

For items of income after the enactment date, RE FX Gain is excluded for purposes of both Income Tests, and Passive FX Gain is excluded for purposes of the 95% Income Test but included for purposes of the 75% Income Test as non-qualifying income. The intent of the exclusions is to make it easier for a REIT that operates in a foreign jurisdiction to qualify under the Income Tests. In addition, the new exclusionary rule for REIT branches will allow a REIT to operate directly in a foreign country using a foreign currency rather than setting up a separate REIT or taxable REIT subsidiary to operate in the foreign country. It should be noted, however, that RE FX Gain and Passive FX Gain are excluded solely for purposes of the Income Tests. Both types of gain will continue to be income that must be distributed to REIT shareholders in order to avoid a corporate level tax.

The Act also expands the exclusionary rule to a wider range of clearly identified hedges entered into after the enactment date. Under prior law, the exclusionary rule was restricted to income from hedging transactions relating to indebtedness incurred to acquire or carry real estate assets and only applied for purposes of the 95% Income Test. This meant that any income generated from a clearly identified hedging transaction would constitute non-qualifying income for purposes of the 75% Income Test and would not be excluded for purposes of the 95% Income Test if the transaction did not hedge "debt" related to a real estate asset. The Act extends the prior hedging income exclusion rule by giving hedging income generated from indebtedness related to a real estate asset parallel treatment under the 75% Income Test and the 95% Income Test. The Act also expands exclusion of hedging income to transactions entered into by a REIT primarily to manage currency fluctuations with respect to any item of qualifying income under both Income Tests. Thus, hedging transactions that manage currency risk with regard to real property rents, mortgage interest, dividends, and sales of non-dealer property will all be covered by the new exclusionary rule. As a result, the Act provides a REIT with assurance that it may enter into various types of hedging transactions without the fear that the income generated will compromise its REIT status. As a response to any future items in which qualifying income treatment is uncertain, the Act specifically empowers the IRS to issue additional guidance that excludes or includes other items of income for REIT qualification under the Income Tests.

Other REIT Rules

The Act also relaxes certain other REIT rules, for example the modified rules under the Asset Test (as defined below), thus allowing REITs to manage risk and adjust to changing market conditions. In addition to qualification under the Income Tests, at each quarter-end an entity must meet several rules (the "Asset Test") in which: (i) at least 75% of the total value of an entity's assets is represented by real estate assets,[3] cash (and cash items) and government securities; (ii) no more than 25% of an entity's assets are securities other than real estate assets; (iii) no more than 5% of the value of an entity's assets are securities of any one issuer; and (iv) the entity possesses no more than 10% of the outstanding vote or value of any one issuer. In general, an entity's REIT status is protected from discrepancies arising solely from market fluctuations in valuing the entity's assets in a subsequent quarter as long as the discrepancy does not arise from an acquisition of any security or other property (the "Market Fluctuation Rule"). The Act expands the Market Fluctuation Rule, for tax years beginning after July 2008, to include discrepancies resulting from fluctuations in foreign currency exchange rates that occur while an entity holds foreign assets. In effect, the exclusion of discrepancies resulting from fluctuations in foreign currency rates under the Market Fluctuation Rule will prevent such fluctuations from adversely affecting an entity's REIT status.

The Act also eases certain REIT rules related to taxable REIT subsidiaries ("TRSs"). As mentioned above, a REIT is not allowed to own more than 10% of the vote or value of an issuer under the Asset Test. As an exception to this rule, Code Section 856(c)(4) provides that up to 20% of the value of the REIT's assets may be invested in a TRS, an entity that is taxed as a corporation. In general, a TRS may engage in the operation of any kind of business, except in the case of a lodging facility or health care facility. However, a TRS will be permitted to lease a transient lodging facility (e.g., hotel or motel) from its parent REIT as long as the TRS hires an independent contractor to operate such facility ("lease exception"). Under a separate provision, rents paid by a TRS to its parent REIT under a transient lodging facility lease will be qualifying income to the REIT for purposes of the Income Tests.

For tax years beginning after the enactment date, the Act increases the asset percentage limitation on a REIT's interest in a TRS from a 20% limitation to a 25% limitation. In addition, the Act expands the lease exception to cover a TRS that rents a health care facility from its parent REIT. As with the lease exception applicable to transient lodging facilities, a TRS must hire an independent contractor to operate the health care facility in order to qualify for the exception. The Act also specifies that the REIT's receipt of rental income from such a health care facility lease will constitute qualifying income under the Income Tests. Consequently, the more generous 25% limitation and favorable treatment of health care facilities will enable a REIT to earn more non-qualifying income through one or more

TRSs without jeopardizing its status as a REIT under the Asset Test.

Finally, the Act also makes significant changes to the REIT safe harbor for dealer sales under the prohibited transaction rules. In general, the prohibited transaction rules subject a REIT to a 100% tax on net income derived from the sale or disposition of property that is stock in trade, property includible in inventory, or property held for sale to customers in the ordinary course of a trade or business.[4] Under prior law, a prohibited transaction tax did not apply to a REIT's sale of a real estate asset if certain safe harbor requirements were met, including a four year holding period for the asset. To qualify for the safe harbor under prior law, a REIT was also required to either: (i) make no more than seven sales within a tax year, or (ii) sell no more than 10% of the aggregate basis of all the REIT's assets as of the beginning of the tax year (the "Sales Restriction Test"). For sales of applicable items occurring after the enactment date, the minimum holding period under the safe harbor is reduced from four years to two years. Also, a REIT will satisfy the Sales Restriction Test if it sells no more than 10% of the aggregate "fair market value" of all its assets, thus providing a REIT with the option to use fair market valuation over basis valuation under the Sales Restriction Test. In effect, the alternative Sales Restriction Test and reduced holding period under the Act will allow REITs greater flexibility to dispose of property without incurring a prohibited transaction tax.

Footnotes

[1] Internal Revenue Code ("Code") Sections 856(c)(2) and (3).

[2] *See*,Revenue Ruling 2007-33, 2007-21 I.R.B. 1281; Notice 2007-42, 2007-21 I.R.B. 1288. For prior coverage of Rev. Rul. 2007-33 and Notice 2007-42, *see* our Client Alert, *IRS Issues Guidance Relating to the Treatment of Foreign Currency Gains of Real Estate Investment Trusts*, at http://www.mofo.com/news/updates/files/12367.html

[3] Real estate assets include real property, interests in real property, mortgages on real property, and shares in other REITs. Code Section 856(c)(5)(B).

[4] Code Section 857(b)(6)(B).