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REIT Provisions in the Housing and Economic Recovery Act of 2008

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The Housing and Economic Recovery Act of 2008[1] (the "**Act**") includes significant modifications to the treatment of real estate investment trusts ("**REITs**") under the Internal Revenue Code of 1986, as amended (the "**Code**").

Dealer Sales and the Prohibited Transactions Tax Safe Harbor

Background. A REIT is subject to a tax equal to 100% of its net income from prohibited transactions for each taxable year. Prohibited transactions are generally dealer sales (*i.e.*, sales of inventory or sales of property held primarily for sale to customers in the ordinary course of the REIT's trade or business) other than sales of foreclosure property. The tax applies to income from prohibited transactions reduced by certain related deductions, but not reduced by losses from prohibited transactions. Under a statutory safe harbor, certain sales by a REIT are deemed to not constitute prohibited transactions if the requirements of the safe harbor are met.

Change in Law. The Act reduces the holding period requirement in the safe harbor from four years to two years and provides an alternative for satisfying the limitation on significant sales activities by the REIT based on aggregate asset values in addition to aggregate asset bases.

Amended Safe Harbor. The statutory safe harbor as amended by the Act provides that sales by a REIT are not prohibited transactions provided that:

(1) the REIT holds the property for at least two years

- compared to four years under prior law

(2) the REIT does not incur capital expenditures with respect to the property in excess of 30% of the net sale proceeds during the two-year period before the sale

- compared to the four-year period before the sale under prior law

(3) either (A) the REIT does not make more than seven sales of property during the taxable year, (B) the aggregate adjusted bases of all the REIT's properties sold during the taxable year do not exceed 10% of the aggregate bases of all the REIT's assets at the beginning of the taxable year, or (C) the aggregate fair market value of all the REIT's properties sold during the taxable year does not exceed 10% of the aggregate fair market value of all the REIT's assets at the beginning of the taxable year

- compared to prior law, which did not provide the 10% fair market value alternative in (3)(C)

(4) if the REIT makes more than seven sales of property during the taxable year, then substantially all the marketing and development expenditures with respect to the property are made through an independent contractor from whom the REIT derives no income

- no change from prior law

In addition, the Act clarifies that the prohibited transactions tax applies to income from prohibited transactions reduced by related deductions and also by related foreign currency loss.

REIT Treatment of Foreign Currency Gains

Background. In general, a REIT must satisfy two annual income tests (together, the "**Income Tests**") pursuant to which at least 75% of a REIT's gross income must be derived from real estate investments (including mortgages) or from certain temporary investments (the "**75% Income Test**"), and at least 95% of a REIT's gross income must be derived from real estate investments and certain other passive income such as dividends, interest and gain from the sale of stock and securities (the "**95% Income Test**"). In addition, at the close of each quarter of a REIT's taxable year, at least 75% of the total value of its assets must consist of real estate assets, cash and cash items, and Government securities (the "**Asset Test**"). Prior to the Act, the Code did not clarify how a REIT should treat its foreign currency gains for purposes of the Income Tests. The Internal Revenue Service (the "**IRS**") published guidance in 2007 regarding the appropriate treatment by a REIT of certain types of foreign currency gains, but this guidance was limited in scope and left significant uncertainty with respect to the appropriate treatment of foreign currency gains in other contexts.

Change in Law. The Act modifies and expands the previous IRS guidance on the appropriate treatment of foreign currency gains of a REIT for purposes of the Income Tests. The Act provides that "real estate foreign exchange gain" is not "gross income" for purposes of both Income Tests and "passive foreign exchange gain" is not "gross income" for purposes of the 95% income test.

"Real estate foreign exchange gain" includes:

(1) foreign currency gains under Code Section 988[2] attributable to any item of qualifying income under the 75% Income Test or to acquiring, owning or becoming the obligor under certain obligations secured by real property mortgages or real property interests;

(2) foreign currency gains under Code Section 987,[3] provided that the REIT's qualified business unit ("**QBU**") would itself independently satisfy the 75% Income Test and the Asset Test for any taxable year or quarter, respectively, that such QBU is owned by the REIT; and

(3) other appropriate items of foreign currency gain as determined by the Secretary of Treasury.

"Passive foreign exchange gain" includes:

(1) any "real estate foreign exchange gain";

(2) foreign currency gains attributable to any item of qualifying income under the 95% Income Test;

(3) foreign currency gains attributable to acquiring, owning or becoming the obligor under general obligations (other than gains attributable to obligations included in "real estate foreign exchange gain"); and

(4) other appropriate items of foreign currency gain as determined by the Secretary of Treasury.

In general, the Act treats foreign currency gains other than "real estate foreign exchange gain" and "passive foreign exchange gain" as non-qualifying income includible in the denominator but not the numerator of the Income Test fraction.

The Act also provides that foreign currency qualifies as "cash or cash items" for purposes of the Asset Test (provided that the REIT uses such foreign currency as its functional currency and the currency relates to activities generating qualifying REIT income).

Treatment of Hedging Transactions

Background. Prior to the Act, income of a REIT derived from hedging transactions was not treated as "gross income" for purposes of the 95% Income Test if the hedge was clearly identified and entered into only to hedge indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.

Change in Law. The Act extends the hedging transaction exception to apply to the 75% Income Test. In addition, the Act provides that "gross income" for purposes of the Income Tests does not include income from certain hedging transactions entered into by a REIT primarily to manage the risk of currency fluctuations with respect to an item of income or gain that is qualifying income for purposes of either Income Test. In order for such income to be excluded, the REIT must clearly identify the hedging transaction before the close of the day on which it was acquired, originated or entered into.

As a result of these changes, a REIT may now enter into qualified hedging transactions with respect to its real estate borrowings without the limitations of the 75% Income Test and may hedge currency rates on qualifying income.

Regulatory Authority to Exclude Other Income Items from Income Tests

Background. The Code provisions related to the Income Tests do not contemplate various items of income that are directly related to qualifying income items under the Income Tests or qualifying assets under the Asset Test. The IRS has issued private letter rulings permitting certain taxpayers to exclude such items from the numerator and denominator of the Income Test fraction. The legislative history to the Act provides two examples of various income items that the IRS has appropriately excluded from the Income Test fraction in private letter rulings: a settlement payment received by a REIT with respect to construction of a mall, and a payment received by a REIT as a "breakup fee" in a proposed merger.[4]

Change in Law. The Act grants the Secretary of Treasury authority to issue guidance where appropriate to treat certain items of income as qualifying income for the Income Tests or to exclude such items from the definition of "gross income" for purposes of the Income Tests.

Amendments Affecting Taxable REIT Subsidiaries and Health Care REITs

Background. Prior to the Act, the value of a REIT's investment in taxable REIT subsidiaries ("**TRSs**") could not exceed 20% of the REIT's gross assets. TRSs could not directly or indirectly operate or manage lodging facilities or health care facilities, and REITs could not receive qualifying income in the form of rents from related parties (including TRSs). A limited exception was available for rent paid by TRSs that operated qualified lodging facilities through an eligible independent contractor.

Change in Law. The Act provides that the value of a REIT's investment in TRSs cannot exceed 25% of the REIT's gross assets. In addition, the TRS related-party rent exception previously applicable only to qualified lodging facilities now applies to health care facilities as well. Thus, provided that the health care facility is operated

through an eligible independent contractor, a TRS may indirectly operate such health care facility and pay qualifying rents to its parent REIT with respect to such health care facility. Finally, a TRS will not be treated as directly operating a qualified health care facility or qualified lodging facility solely because it possesses a license to do so or because it directly employs individuals working at such a facility outside the United States, provided that an eligible independent contractor is responsible for the daily supervision of such employees of the TRS.

Effective Dates

In general, the provisions in the Act related to REITs are effective for taxable years beginning after July 30, 2008. However, the provisions described above regarding REIT treatment of foreign currency gains, hedging transactions and the prohibited transactions tax safe harbor will apply to income and gains recognized, and to sales made, after July 30, 2008, without regard to the taxpayer's taxable year.

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[1] P.L. 110-289, signed by President Bush on July 30, 2008.

[2] In general, Code Section 988 foreign currency gain is income and gain received in, or determined by reference to, a currency other than the taxpayer's functional currency, and attributable to acquiring or issuing debt instruments, accruing income or gain payable on a later date, or entering into forward contracts, futures contracts, options and related instruments.

[3] In general, Code Section 987 foreign currency gain is gain attributable to translating the income or gain of a taxpayer's qualified business unit with a functional currency other than the U.S. dollar, or to the transfer of property from such qualified business unit.

[4] *See* Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221* (JCX-63-08), July 23, 2008.