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TAX TRANSACTIONS UPDATE

Housing and Economic Recovery Act of 2008 Provides Reforms to REIT Rules

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On July 30, 2008, President Bush signed into law H.R. 3221, the Housing and Economic Recovery Act of 2008 (the "Act"). The Act provides significant beneficial changes and clarifications relating to the taxation of real estate investment trusts (REITs) under the Internal Revenue Code of 1986, as amended, (the "Code"). The Act's provisions relating to REITs are generally effective for taxable years beginning after the date of enactment. Generally, the Act addresses foreign currency exchange gain, Treasury authority regarding other items of income under the income tests, prohibited transaction safe harbors, ownership of taxable REIT subsidiaries (TRSs) and the treatment of health care facilities.

Background

Under the Code, a domestic corporation that elects to be taxed as a REIT, and that meets the requirements for REIT status, is entitled to a dividends paid deduction for distributions made to its shareholders (effectively eliminating corporate level taxation). In order to maintain its REIT status, a REIT must meet two income tests — a 75 percent test and a 95 percent test, which are designed to ensure that the REIT primarily is engaged in generating passive real estate related income — and two asset tests — a 75 percent and a 25 percent test, which are designed to ensure that the bulk of a REIT's assets consist of real property.

Foreign Currency Gain

Prior to enactment of the Act, it was uncertain whether foreign currency gains (i.e., gain from translating foreign currency to US dollars) were qualifying income under the income tests. While the Internal Revenue Service (the "Service"), in Rev. Rul. 2007-33, held that currency gain described in Section 988 of the Code will be qualifying income for purposes of the income tests to the extent the underlying income so qualifies, no guidance existed regarding the treatment of currency gain described in Section 987 of the Code (relating to a taxpayer's business units with a functional currency other than the US dollar). Many REITs structured around this issue with REIT subsidiaries (and the Service issued certain private letter rulings with respect to such structures). However, under the Act, Section 856 of the Code now provides that certain foreign currency gains recognized under Sections 987 and 988 of the Code are excluded from computation of the income tests. Therefore, such currency gain will neither increase a REIT's denominator (of qualifying income) in determining its status under the income tests nor be considered

non-qualifying income. In establishing this exclusion rule, the Act creates two categories of income: real estate foreign exchange gain and passive foreign exchange gain. Each term is defined and subject to special treatment under the new provisions.

In addition, the Act amends the rules relating to the treatment of hedging under Section 856(c)(5)(G) of the Code to exclude certain hedging income (already excluded from the 95 percent income test) from the 75 percent income test, and extends this exclusion to income from transactions entered into primarily to manage the risk of currency fluctuations with respect to any item of income that would be qualifying income under the income tests.

For purposes of the asset tests, the Act also provides, generally, that the term "cash" includes foreign currency when such foreign currency is used as the REIT's (or its qualified business unit's) functional currency and is held for use in the normal course of its activities, and that a REIT will not fail an asset test solely because of a discrepancy due to certain variations in value that are caused by changes in foreign currency exchange rates.

These currency gain rules are effective to transactions entered into after July 30, 2008.

Treasury Authority for Other Items of Income

In an effort to clarify the extent of the government's regulatory authority in the area, the Act authorizes the Treasury to determine whether any item of income that is currently not provided for under the income tests may be considered qualifying income. The legislative history makes clear that "[u]nder this authority, it is expected that, for example, the IRS would conclude that dividend-like items such as Subpart F deemed dividends and PFIC income would be treated in the same manner as dividends for purposes of the 95 percent gross income test."

This authority is effective immediately after July 30, 2008.

Prohibited Transaction Safe Harbors

Section 857(b)(6) of the Code provides a 100 percent tax on a REIT's net income derived from prohibited transactions. A prohibited transaction is a sale (or other disposition) of property held primarily for sale to customers in the ordinary course of business. Under current law, the Code provides a safe harbor from such prohibited transactions if, among other requirements, the property sold has been held for not less than four years, and either (i) the aggregate adjusted bases of property sold by the REIT during the taxable year does not exceed 10 percent of the aggregate bases of all the assets of the REIT at the beginning of the taxable year or (ii) during the taxable year the REIT does not make more than seven sales of property.

The Act shortens the four year safe harbor holding requirement to two years. The Act also provides an alternative to the 10 percent aggregate bases safe harbor by adding that the safe harbor requirement may also be met if the *fair market* value of property sold by the REIT during the taxable year does not exceed 10 percent of the *fair market* value of all the assets of the REIT at the beginning of the taxable year.

These changes are effective to sales made after July 30, 2008.

Ownership of Taxable REIT Subsidiaries

REITs frequently form a TRS to conduct activities that would otherwise generate non-qualifying income.

While a REIT generally cannot own more than 10 percent (by vote or value) of a single issuer, there is an exception for a TRS under Section 856(c)(4)(B)(ii) of the Code, provided that the securities of one or more TRSs do not represent more than 20 percent of the value of the REIT's assets. The Act increases the limitation on ownership of TRSs to 25 percent.

Treatment of Health Care Facilities

Under Section 856(d)(2) of the Code, rent that would otherwise be qualifying income will not be considered qualifying income if received from a "related party." However, Section 856(d)(8)(B) of the Code provides a special rule for qualified lodging facilities (e.g., a hotel) leased by a REIT to its TRS, which provides that, if such property is operated by an independent contractor, rent paid by the TRS to the REIT will be considered qualifying income for the income tests.

The Act expands this special rule to include qualified health care properties, so that rent paid by a TRS to the REIT with respect to a qualified health care facility operated by an independent contractor is qualifying income. In addition, the Act generally provides that a TRS will not be considered as operating the facility merely because the TRS has the right to operate pursuant to a license or similar instrument, or because the TRS employs employees working at such facility outside the Unites States, as long as an independent contractor is in fact responsible for operating the facility on a day-to-day basis.

If you have questions, we would be pleased to provide additional details about the Act or advice about how the Act might affect your business or practice. For more information, please contact any of the attorneys listed below or any member of our Transactional Tax practice.

Jeffrey Bruns
+1 312 701 8793
jbruns@mayerbrown.com

Anne Marie Konopack
+1 312 701 8467
akonopack@mayerbrown.com

William Levy
+1 312 701 8049
wlevy@mayerbrown.com

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