goulston&storrs
counsellors at law

clientalert

August 2008

New Housing Bill Includes Many Favorable REIT Provisions

On July 30, 2008, President Bush signed into law H.R. 3221, the Housing and Economic Recovery Act of 2008 (the "Act"). Besides the well-publicized sections of the Act dealing with shoring up home ownership in the current economic climate, the Act also contains sections implementing certain long-sought reforms to the tax rules governing real estate investment trusts ("REITs") and other selected real estate-related matters. We provide a brief summary of these provisions of the Act below.

REIT-Related Provisions

Liberalizing the Safe Harbor for Dealer Sales for REITs – 2-Year Safe Harbor and 10% FMV Limit

A 100% tax is imposed on a REIT's net income derived from sales of properties which are held primarily for sale to customers in the ordinary course of business. Such sales are known as "prohibited transactions" or "dealer sales," and the rules are meant to ensure that a REIT holds real estate primarily for investment.

Prior to the enactment of the Act, the REIT rules contained a safe harbor test, which, when satisfied, ensured that a sale would not be considered a prohibited transaction. The safe harbor was as follows:

1. The REIT held the property for 4 or more years;
2. During the 4-year period prior to the sale, the aggregate capital expenditures made on the property by the REIT were not more than 30% of the selling price;
3. During the taxable year in which the sale occurs (a) the REIT does not make more than 7 sales of property (the "7-sales limit"); *or* (b) the aggregate tax bases of property sold do not exceed 10% of the aggregate tax bases of all of the REIT's properties at the beginning of such taxable year (the "10% basis limit");
4. In the case of property not acquired through foreclosure or lease termination, the REIT has held the property for 4 or more years for production of rental income.

The Act modifies and liberalizes the safe harbor in two ways. First, it shortens the holding period that a REIT must own a property before the sale from 4 to 2 years. Second, as an addition to the 7-sales limit and the 10% basis limit as alternatives for satisfying requirement 3 of the safe harbor, the Act adds a third alternative: if the fair market value of property sold during the taxable year does not exceed 10% of the fair market value of all of the assets of the REIT as of the beginning of the taxable year (the "10% FMV limit"). It appears that a REIT may annually elect to use the 10% basis limit or the 10% FMV limit on its tax return.

Increasing the Taxable REIT Subsidiary Limit to 25%

Prior to the enactment of the Act, the REIT rules required that, at the end of each quarter, no more than 20% of the value of a REIT's total assets be represented by stock in taxable REIT subsidiaries ("TRSs"). The Act increases this limit to 25%, matching the maximum amount of non real estate assets that a REIT may hold.

Conformity of Treatment of Healthcare Facilities with Lodging Facilities

Generally, rent income received by a REIT from a TRS owned by it is not qualified income for the REIT. However, in addition to other limited exceptions, an exception exists for a TRS which leases "qualified lodging facilities" from its REIT owner, provided that the lodging facility is operated by an "eligible independent contractor". In such a case, the rent paid by the TRS to the REIT parent would be treated as rents from real property.

The Act expands this rule to qualified healthcare properties. Moreover, the Act clarifies the law in important ways: a TRS conducting its activities through an eligible independent contractor will not be considered to be operating or managing a healthcare facility or a lodging facility solely because (1) it owns a license or permit to do so; or (2) it is considered the employer of the employees at the facility under local law, so long as the day-to-day supervision and direction of such employees is the responsibility of the eligible independent contractor. These clarifications should prove helpful to healthcare REITs and hotel REITs.

Certain Foreign Currency Gains Excluded From Income Tests

Generally, a REIT must satisfy certain income and asset tests in order to continue to qualify as a REIT. In particular, at least 95% of the gross income of a REIT in any taxable year must be from "passive" sources such as rents from real property, dividends, and interest (the "95% income test"), and at least 75% of a REIT's gross income for any taxable year must be derived from real property sources, primarily rents from real property and interest from mortgages (the "75% income test"). Also, at least 75% of the assets of a REIT must be in the form of real estate assets (which includes investment in mortgages and other REITs), cash and cash items, and government securities (the "75% asset test"). These tests are designed to ensure that REITs remain primarily vehicles for real estate investment so as to justify their special tax treatment.

Prior to the enactment of the Act, there was some uncertainty as to how foreign currency gains that a REIT generates from overseas operations should be classified under the income tests. The Act clarifies these issues.

Under the Act, generally, effective immediately, foreign currency gains of any separately identifiable business unit (a "qualified business unit," in technical terms) of a REIT are entirely excluded from the income tests (that is, excluded from both the numerator and the denominator of the percentage calculations) so long as the business unit itself, if considered separately, would satisfy the 75% income test and the 75% asset test. The Act also makes a number of other related changes to the REIT rules as to the treatment of foreign currency gains and foreign currency holdings.

Treasury Authority to Issue Guidance On Treatment Of Other REIT Income Items

As the example of foreign currency gains shows, taxpayers are continuously encountering situations involving new types of income which are not specifically described in the qualifying categories contained in the income tests described above. Prior to the enactment of the Act, the Treasury did not have explicit rule-making authority to remedy the situation. Effective immediately, the Act expressly gives the Treasury the authority to issue guidance to either exclude items of income from the income tests or to treat them as qualifying income under the income tests.

Effective Dates for REIT Provisions

The Act's REIT provisions are generally effective for taxable years beginning after July 30, 2008. However, certain provisions (such as the new safe harbor rules for dealer sales, the new authority given to the Treasury for issuing guidance on new types of REIT income, and the treatment of foreign currency gains) will take effect immediately for gains recognized and transactions entered into after July 30, 2008.

Other Selected Real Estate-Related Tax Matters

Repeal of Alternative Minimum Tax Limitations on Use of Low Income Housing Tax Credit and Rehabilitation Tax Credits

Prior to the enactment of the Act, certain tax credits, including the low-income housing credit (under Code Section 42) and the rehabilitation credit (under Code Section 47) were not allowed to reduce a taxpayer's net income tax below the greater of (1) the taxpayer's tentative minimum tax, and (2) 25% of the portion of the taxpayer's net regular tax which exceeds $25,000. The effect under prior law is that these credits could not be applied against an individual's alternative minimum tax.

The Act removes this limitation for the low-income housing credit and the rehabilitation credit. The change is effective for low-income housing credits attributable to buildings placed in service after December 31, 2007, and for rehabilitation credits attributable to rehabilitation expenditures taken into account after December 31, 2007.

Modification of Rules for FIRPTA Nonforeign Affidavits

Prior to the enactment of the Act, in order to avoid withholding under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), it was necessary for the seller in a real estate transaction to furnish to the buyer an affidavit stating, among other required information, that the seller is not a foreign person.

Effective for transactions occurring after July 30, 2008, the Act provides for an alternative procedure for using the FIRPTA affidavit to avoid withholding. Instead of giving the affidavit to the buyer, the seller can give the affidavit to a "qualified substitute" (generally the attorney or title company responsible for closing the transaction or the buyer's agent), and the qualified substitute can give a statement, under penalty of perjury, to the buyer that it is in possession of such an affidavit.

For questions regarding the information contained in this client alert, please contact your customary Goulston & Storrs attorney or:

Boston
John R. Grumbacher 617-574-6551
jgrumbacher@goulstonstorrs.com

Robert S. Towsner 617-574-6438
rtowsner@goulstonstorrs.com

Washington, D.C.
Steven R. Schneider 202-721-1145
sschneider@goulstonstorrs.com

Pursuant to IRS Circular 230, please be advised that, this communication is not intended to be, was not written to be and cannot be used by any taxpayer for the purpose of (i) avoiding penalties under U.S. federal tax law or (ii) promoting, marketing or recommending to another taxpayer any transaction or matter addressed herein.

This client advisory should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your own lawyer concerning your situation and any specific legal questions you may have.

© 2008 Goulston & Storrs – A Professional Corporation All Rights Reserved