NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

Statement of the National Association of Real Estate Investment Trusts® to the Committee on Finance U.S. Senate regarding S. 1447 The "Tax Technical Corrections Act of 2005"

The National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Finance Committee's review of S. 1447, the "Tax Technical Corrections Act of 2005." (the TTCA). The TTCA includes technical corrections to, among other things, the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (the Jobs Act) including certain provisions relating to real estate investment trusts, which was signed into law on October 22, 2004. NAREIT thanks the Chairman and the Committee for the opportunity to share its views on several important, but technical, issues relating to the Jobs Act's effect on real estate investment trusts.

NAREIT is the representative voice for United States real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

EXECUTIVE SUMMARY

By way of background, the Jobs Act contains all three titles of the NAREIT-supported REIT Improvement Act (RIA), which was introduced as S. 1568. First, Title I of the RIA includes a number of provisions, including one that allows a REIT to make certain loans in the ordinary course of business without the risk of losing REIT status and another that permits timberland dispositions to qualify for a new safe harbor from the 100% prohibited transactions tax. Second, Title II of the RIA substantially conforms the treatment under the FIRPTA rules of foreign shareholders in publicly traded REITs to that of foreign shareholders in other publicly traded U.S. companies. Finally, Title III of the RIA (the REIT Savings provisions) allows companies to avoid REIT disqualification for unintentional REIT test violations either by, among other things, paying a monetary penalty if the violation was due to reasonable cause or, for certain *de minimis* violations, by bringing themselves into compliance with the REIT rules

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Because certain provisions of the Jobs Act could have resulted in retroactive REIT disqualification and/or considerable additional expense, NAREIT submitted written comments to the tax-writing Committees suggesting certain clarifications to the REIT-related provisions in the Jobs Act. NAREIT would like to thank the Senate Finance Committee for favorably addressing these RIA-related changes. However, we have been informed by practitioners that there still may be some potential ambiguity concerning the application of a few of the TTCA provisions concerning effective date issues. Accordingly, as further described below, we have requested further clarification either in statutory language or legislative history. In addition and as further described below, we respectfully request that cross-references be updated in connection with the new safe harbor from the 100% prohibited transactions tax for timberland dispositions. Finally, NAREIT requests the Committee to clarify that REITs are not considered "pass-thru entities" for purposes of § 470 of the Internal Revenue Code, as amended (the Code)[1].

The specific RIA-related items are as follows:

1) a clarification to the transition rule concerning the calculation of "safe harbor securities" under § 856(m)(1) in order to prevent retroactive disqualification of REITs that had held qualifying securities and other securities in compliance with the provisions of pre-Act § 856(c)(7) but did not continue to hold such securities on the date of enactment of the Jobs Act (or shortly thereafter);

2) clarification either to the statutory language or the legislative history of the REIT Savings procedures, so that it is clear that it applies to failures of the REIT tests (including those with respect to taxable years prior to date of enactment of the Jobs Act) that are discovered and satisfied after October 22, 2004.

3) a clarification either to the statutory language or the legislative history of the "deficiency dividend" procedure, so that it is clear that statements filed with the IRS in taxable years beginning after October 22, 2004 can relate to distribution errors that occurred in earlier taxable years as well;

4) a clarification of the effective date of the new FIRPTA provisions of the Jobs Act to include "deficiency dividends" of capital gains attributable to pre-Jobs Act years; and,

5) an update of a cross reference in the REIT provisions of the Internal Revenue Code concerning the new safe harbor from the 100% tax for timber sales, to clarify that, based on all the surrounding facts and circumstances, a sale can avoid characterization as a "prohibited transaction" even if all of the requirements of the new safe harbor are not satisfied.

[1] Unless otherwise provided, all "section" or "§" references in this submission shall be to a section of the Code. § 470 was added by the Jobs Act.

DISCUSSION

A. Transition Rule for Expansion of "Straight Debt" Safe Harbor

1. Background

In general, a REIT may not own more than 10% of the value of any other entity's securities other than those of a taxable REIT subsidiary (TRS) or another REIT. Prior to enactment of the Jobs Act, an exception to this rule existed for securities that met the definition of "straight debt," and, in the case of "straight debt" securities issued by a partnership, the exception required (at least for REITs that held non-straight debt and equity partnership securities) that the REIT own at least a 20% profits interest in a partnership. Unfortunately, this straight debt exception did not apply to many situations in which individuals and/or businesses owed some debt to a REIT, including non-abusive loans issued in the ordinary course of business.

2. Jobs Act Change and Technical Issue

The Jobs Act exempted from the 10% test categories of loans that are non-abusive and presented little or no opportunity for the REIT to participate in the profits of the issuer's business. The Jobs Act also eliminated the requirement that a REIT hold a 20% profits interest in a partnership, but included a limitation that could disqualify from the new "straight debt" safe harbor otherwise qualifying debt securities if the REIT owned non-qualifying securities in the partnership with a value in excess of 1% of the partnership's outstanding securities. § 856(m)(2)(C). The Jobs Act also included a new safe harbor for partnership debt securities that prospectively treats them as qualifying "safe harbor" securities if at least 75% of the partnership's gross income is from the "real estate-related" sources described in Code section 856(c)(3) (such as mortgages and rents).

NAREIT applauds Congress' leadership in enacting these changes and appreciates greatly that they were made on a retroactive basis to 2001, in recognition of the fact that prior to the amendment the "straight debt" rules did not reflect the regulatory regime Congress had originally intended.

Nevertheless, several practitioners have raised the concern that the Jobs Act's retroactive change concerning partnership debt could have resulted in retroactive failures of the asset test for certain REITs that had complied with the provisions of the prior "straight debt" safe harbor, and, accordingly, NAREIT submitted comments to the tax-writing committees expressing this concern. For example, under the Jobs Act, a REIT that owned the following securities in a partnership prior to the enactment of the Act would have been in full compliance with prior law but would fail the 10% value test retroactively after the Jobs Act: (a) at least a 20% profits interest in the partnership; (b) "straight debt" securities under § 856(c)(7) (and under § 856(m)(1) prior to the application of § 856(m)(2)(C)) with an aggregate value in excess of 10% of the partnership's outstanding securities; and (c) non-"straight debt" securities with an aggregate value greater than 1%, but less than 10%, of the partnership's outstanding securities that do not qualify for the "real estate partnership" exception.

3. TTCA Creation of a Transition Rule

In general, the TTCA evidences the intent to make the Jobs Act's revisions to the prior law "straight debt" safe harbor apply prospectively when the Jobs Act provisions are stricter than prior law. The TTCA 2005 would clarify that securities of a partnership that are held by a REIT on or after October 22, 2004, and that would have qualified and continue to qualify as straight debt of that partnership under prior law rules that required a REIT (that held any partnership equity) to hold at least 20% of the partnership equity, will continue to so qualify while held by that REIT (or successor) until the earlier of the disposition or the original maturity date of the securities.

4. Potential Issues Raised by TTCA Statutory Language

a. REIT Disposed of Pre-Jobs Act Qualifying Securities Prior to October 22, 2004

One potentially outstanding issue regarding the TTCA "straight debt" change is that the TTCA requires that the securities have been held by the REIT on October 22, 2004, and continuously thereafter. However, the TTCA did not otherwise change the Jobs Act's retroactive amendment to the prior law "straight debt" exception. As a result, it would appear that it still may be possible for a REIT that held a 20% profits interest in a partnership, along with other qualifying and non-qualifying debt securities, and which met the pre-Jobs Act "straight debt" safe harbor prior to its retroactive change by the Jobs Act on October 22, 2004, but which disposed of the non-qualifying securities prior to October 22, 2004 to face retroactive disqualification because it would not be holding the 20% profits interest in the partnership on October 22, 2004.

b. REIT Disposed of Pre-Jobs Act Partnership Equity Interest Shortly After October 22, 2004

Another potential issue stems from the fact that the TTCA appears to require a REIT that potentially faced retroactive disqualification under the Jobs Act due to its ownership of a 20% profits interest in a partnership in which it also held "straight debt" securities to continue to own a 20% profits interest following the enactment of the Jobs Act in order for its previously qualifying straight debt securities to continue to be considered "straight debt."

Following enactment of the Jobs Act on October 22, 2004, REITs that faced this retroactive disqualification may have disposed of their partnership profits interest bringing themselves into compliance on a going-forward basis and hoping that any modification to the retroactivity issue raised by NAREIT would be solved only retroactively. Unfortunately, this action appears to eliminate their ability to meet the TTCA 2005's transition rule. Once the REIT no longer holds at least a 20% profits interest, its ownership of other partnership securities may result in the REIT's retroactive disqualification because the REIT would not meet the TTCA's requirement that it continue to comply with the pre-Jobs Act "straight debt" safe harbor.

5. Recommended Solution

We suggest essentially the same solution that we proposed in our earlier comments on this issue. Specifically, we suggest that any technical corrections legislation treat the specific securities held by a REIT (or a successor under § 381) on or prior to October 22, 2004, that qualified as "straight debt" as continuing to qualify for the § 856(m)(1) safe harbor (without requiring continued compliance with the pre-Jobs Act safe harbor following October 22, 2004). By enacting such a rule, a REIT that held both straight debt and non-straight debt partnership securities and a 20% partnership profits interest pre-Jobs Act (in compliance with the then-existing safe harbor), but which disposed of any of the securities before October 22, 2004, would not be retroactively disqualified. Similarly, the REIT that held a similar portfolio of debt securities of a partnership's outstanding securities, along with a 20% profits interest (in compliance with the pre-Jobs Act safe harbor), but disposed of some or all of the profits interest between October 22, 2004 and January 1, 2005, also would not be disqualified retroactively. In the latter case, the REIT would have met the pre-Jobs Act safe harbor for taxable years beginning before October 22, 2004, and the post Jobs Act safe harbor for subsequent taxable years.

B. Clarification That REIT Savings Procedures Apply to Failures of the REIT Tests Both Before and After October 22, 2004 That Are Discovered and Satisfied After October 22, 2004

1. Violation of REIT Tests Under Prior Law

Prior to the Jobs Act change, a REIT could lose REIT status by failing to satisfy a myriad of tests relating to its organizational structure, its sources of gross income, its assets, the distribution of its income, its compliance with various procedures, the transferability of its shares, etc.

2. Jobs Act Change

The Jobs Act allows a REIT that fails the asset tests to avoid disqualification by bringing itself into compliance with the asset tests, and in certain cases, paying a penalty. In addition to provisions relating to failures to satisfy the asset tests, the Jobs Act also imposes a monetary penalty of $50,000 in lieu of disqualification for each reasonable cause failure to satisfy the other REIT tests. Intentional violations continue to result in REIT disqualification.

3. Effective Date of Jobs Act Change

The effective date of the REIT Savings provisions in the Jobs Act, both for violations of the REIT asset tests and for other REIT test violations, was for "taxable years beginning after the date of enactment." This language could be interpreted to mean that if, for example, in 2006, a REIT found a problem with respect to any of REIT requirements relating to 2004 or earlier, the REIT Savings provisions would not apply, Accordingly, NAREIT requested that the REIT Savings provisions be clarified to apply to failures "discovered" in taxable years after date of enactment of the Jobs Act.

4. TTCA 2005 Change to the REIT Savings Effective Date

The TTCA 2005 would amend the effective date for the REIT Savings provisions of the Jobs Act to apply to failures of the REIT tests with respect to which the requirements of the new rules are satisfied after October 22, 2004 (that is, meets the reasonable cause standard if applicable, pays the penalty if applicable, and disposes of assets or otherwise brings itself into compliance). Specifically, in the case of non–*de minimis* failures of the REIT asset tests, the TTCA would modify § 243(g)(4)(A) of the Jobs Act so that it applies to "failures with respect to which the requirements of subparagraph (A) or (B) of section 856(c)(7) . . . are satisfied after date of enactment [October 22, 2004]." (emphasis added).

This change appears to mean, for example, that the new REIT Savings provisions apply starting as early as October 23, 2004, when a REIT discovers an asset test violation and then undertakes to cure it, which is what NAREIT had requested. Because asset test violations only can occur on the last date of each calendar quarter, in such a case, the asset test violation must have occurred no later than the last testing date, or September 30, 2004. Nevertheless, some practitioners had expressed concern that the TTCA would not appear to include errors that may have occurred before October 22, 2004, but that were discovered after such date, and requested clarification of this point.

The concern is that because § 856(c)(7)(A)(ii) requires that the asset test failure be "due to reasonable cause and not willful neglect," technically, a pre-date of enactment asset test failure would have been due to reasonable cause pre-date of enactment, and the TTCA requirement that the requirements of § 856(c)(7)(A) be satisfied after the date of enactment would not be met. A further source of confusion is that the Joint Committee pamphlet (JCS-55-05) describing this provision in the TTCA states on page 5 that "the new rules that permit the curing of certain REIT failures apply to failures with respect to which the requirements of the new rules are satisfied in taxable years of the REIT beginning after date of enactment." (emphasis added). This language is inconsistent with the statutory language, which allows for satisfaction of the new rules presumably immediately after date of enactment, rather than in the next taxable year.

5. Proposed Solution: Clarification in Legislative History or Statutory Language

NAREIT urges that the legislative history clarify (or the statutory language be modified) to make clear that the REIT Savings procedures apply to relevant failures of the REIT tests satisfied in taxable years beginning after date of enactment of the Jobs Act (but the failures that are remedied may have occurred prior to such date). At the very least, the legislative history should use language similar to that contained in the statute and should include an express statement that the intention is to apply the new relief rules to all failures discovered after October 22, 2004.

C. Clarification That Statements Concerning "Deficiency Dividends" Can Relate to Distribution Errors That Occurred in Earlier Taxable Years

Similarly to section B above, the TTCA provision concerning "deficiency dividends" should clarify that the change to § 860 applies to determinations made in taxable years beginning after date of enactment of the Jobs Act and, thus, to errors that may have occurred prior to such date. At the very least, the legislative history should use language similar to that contained in the statute.

D. Clarification of the Effective Date of the New FIRPTA Provisions of the Jobs Act to Include "Deficiency Dividends" of Capital Gains Attributable to Pre-Jobs Act Years

1. Jobs Act Provisions

Prior to the Jobs Act, the "Foreign Investment in Real Property Tax" (FIRPTA) required a foreign investor who received a REIT capital gain distribution to file a U.S. tax return as though the investor were doing business in the U.S and, if the investor was taxable as a corporation for U.S. tax purposes, possibly to pay a "branch profits tax." Furthermore, the REIT was required to withhold a 35% tax on such distribution. The Jobs Act modified this rule to treat a capital gain distribution of a publicly traded REIT to a non-U.S. investor as an ordinary dividend so long as the investor owns 5% or less of the distributing REIT "at any time during the taxable year." The change applied to taxable years beginning after October 22, 2004.

2. Technical Issues Under the Jobs Act

Because deficiency dividends are treated as deductions in the year in which they relate (that is, the year in which the REIT failed to satisfy the distribution test), it is theoretically possible that a REIT could make a deficiency dividend including capital gain distributions in a taxable year beginning after October 22, 2004, that relates to a taxable year that began prior to October 22, 2004. In such a case, the TTCA's change to the FIRPTA rules would not apply because the deduction would relate to a taxable year prior to date of enactment. Certain practitioners have informed us that this issue is substantial enough that could prevent a "clean" opinion to be issued about the non-FIRPTA status of REIT capital gains distributions paid starting in 2005.

3. Proposed Solution

The TTCA clarifies that the FIRPTA change applies to any distribution of a REIT that is treated as a deduction of a REIT for taxable years beginning after date of enactment. NAREIT suggests that this provision be modified so it also applies to capital gain deficiency dividends that are paid after October 22, 2004.

E. Update Cross References in the REIT Provisions of the Code Concerning the New Safe Harbor from the 100% Prohibited Transactions Tax for Timber Sales

1. Jobs Act Created Safe Harbor from 100% Tax For Timberland Dispositions

The Jobs Act establishes a new safe harbor from the 100% prohibited transactions tax on gains attributable to the sale of "dealer property" for sales of timberland. This change is accomplished by adding a new subparagraph to § 857(b)(6). Under previous law, which was not amended, § 857(b)(6)(C) provided for a safe harbor from the prohibited transaction tax from sales of rental property if certain requirements were met (the Rental Safe Harbor). Rules of application relating to the Rental Safe Harbor were contained in § 857(b)(6)(D). Further, § 857(b)(6)(E) specifically provided that the Rental Safe Harbor was merely a safe harbor, and a REIT that failed to meet the safe harbor still could avoid the 100% tax by applying a facts and circumstances test as though the Rental Safe Harbor and the attendant rules of application had not been enacted.

Section 321 of the Jobs Act, entitled "Modification of **Safe Harbor** Rules for Timber REITs," (emphasis added), added a new subparagraph (D) to § 857(b)(6) that establishes a safe harbor for property held for the production of timber (the Timber Safe Harbor). It did so merely by redesignating §§ 857(b)(6)(D) and (E) as §§ 857(b)(6)(E) and (F) and inserting new subparagraph (D).

2. Omission of Cross References Including Rules of Application of Timber Safe Harbor and Specific Treatment of Timber Safe Harbor as a Safe Harbor

Although the Jobs Act created the Timber REIT Safe Harbor, it made no other changes to the provisions that referenced subparagraph (C) of § 857(b)(6), the Rental Safe Harbor. As a result, the rules of application contained in former § 857(b)(6)(D) (redesignated § 857(b)(6)(E)) were not extended to the Timber Safe Harbor. Perhaps more importantly, the rules of former § 857(b)(6)(E) (redesignated § 857(b)(6)(F)), allowing a REIT to treat the Rental Safe Harbor as merely a safe harbor, were not extended to the Timber Safe Harbor. As a result, one could make the negative inference that a timber REIT, which under prior law could avoid the 100% prohibited transaction tax if its sold property was not "dealer property" after application of a facts and circumstances analysis, could not do under post-Jobs Act law if it failed to meet the specific Timber Safe Harbor.

3. Proposal

Both the rules of application and the provision treating the Rental Safe Harbor as merely a safe harbor should be extended to apply to timberland sales. Specifically, both subparagraphs (E) and (F) to § 857(b)(6) should be amended to make reference to subparagraph (D) after the reference to subparagraph (C). As a result, property sales by timber REITs, like property sales by REITs that own rental property, will be judged based on the rules of application of § 857(b)(6)(E). Furthermore, adding the reference to subparagraph (D) (the Timber Safe Harbor) in § 857(b)(6)(F) will make clear that the Timber Safe Harbor is in fact merely a safe harbor to avoidance of the 100% prohibited transactions tax, rather than the only way for a transaction to not be considered a prohibited transaction.

F. Clarification that REIT is not "Pass-Thru Entity" Under New Section 470

1. Background

Section 470, added by the Jobs Act, prohibits a taxpayer from claiming a deduction in excess of the taxpayer's gross income with respect to the lease of "tax-exempt use property."[2] The term "tax-exempt use property" is defined by reference to section 168(h), which includes: i) tangible property leased to tax-exempt entities;[3] and, ii) any property owned by a pass-thru entity with a tax-exempt entity as an owner if the pass-thru entity's allocation of items to the tax-exempt does not constitute a qualified allocation.[4] Thus, under section 168(h) and, in turn, section 470, tax-exempt use property includes not only real property leased to tax-exempt entities but also all other real property, regardless of its use, owned by a pass-thru entity with a tax-exempt or foreign owner.[5]

2. Issue

Our concern arises from the fact that neither sections 470 and 168(h) nor the accompanying legislative history defines a pass-thru entity for this purpose. Adding to the uncertainty is the fact that, notwithstanding the general tax treatment of a REIT as a corporation, there are a few instances in the Code in which a pass-thru entity is defined to include a REIT.[6]

The statutory language and legislative history clearly indicate that REITs were not the target of this provision. Instead, section 470 was designed to prevent taxpayers from claiming tax benefits generated in "Sale-In Lease-Out" ("SILO") transactions,[7] which the IRS recently declared to be abusive tax avoidance arrangements.[8] First, a REIT by definition is required to be taxable as a domestic corporation.[9] Further, section 1361(a)(2) states that "[f]or purposes of this title" the term "C corporation" is defined as a corporation that is not an S corporation. Thus, REITs are C corporations for all purposes of the Code unless a Code section otherwise expressly provides. As you know, widely held C corporations rarely are considered pass-thru entities for federal income tax purposes because they cannot pass through losses to their shareholders.[10] In fact, we are not aware of any IRS guidance holding that a REIT is a pass-thru entity in the absence of express statutory direction. Unlike other Code sections, neither section 168 nor section 470 provides that REITs are pass-thru entities rather than C corporations.

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2 Section 470(a).

3 *Id.* § 168(h)(1).

4 *Id.* §§ 168(h)(6)(A), (E).

5 *Id.* § 168(h)(6)(A).

6 *Id.* §§ 1(h)(10)(B); 860E(e)(6)(B); 1260(c)(2).

7 H.R. Rep. No. 108-548, pt. 1, at 313–14 (2004) (noting that the prior law was ineffective in curtailing the ability of a tax-exempt entity to transfer tax benefits to a taxable entity through certain leasing arrangements); S. Rep. No. 108-192, at 198 (2003) (same).

8 Notice 2005-13, 2005-9 I.R.B. 1 (designating SILOs as a listed transaction).

9 Section 857(a)(3).

10 *See*, *e.g.*, section 469(a)(2), which applies the passive loss rules only to individuals, estates, trusts, personal service corporations, and **closely held** C corporations.

Second, even prior to the enactment of section 470, REITs generally had no incentive to engage in a SILO-type transaction because, unlike traditional pass-thru entities (*i.e.*, a partnership), REIT-level losses or credits do not flow through to its shareholders. Further, a REIT generally has little or no taxable income because it may deduct dividends paid to shareholders, and it must distribute most of its taxable income as dividends.[11] Given the tax treatment of REITs, there was no benefit to its shareholders for a REIT to create deductible losses through a SILO arrangement. In fact, one of the most attractive features of investing in a REIT is earning positive income through the high dividend yield that results from the requirement that a REIT must distribute at least 90 percent of its taxable income annually.[12] In most cases, investing in a SILO arrangement actually would have an adverse effect on a REIT because the losses associated with a SILO would decrease REIT taxable income, which, in turn, would decrease the all-important dividend yield of the REIT's stock. Further, presumably the promoters of SILOs price into the transaction tax benefits that investors receive from artificial losses or credits. Thus, SILO transactions should generate less cash to REITs and their investors compared to the economic leasing transactions that are the basis on which REIT investors evaluate REIT management.

A REIT is principally evaluated by the public markets based on the consistency of its income generating capacity and its ability to grow the income stream over time. Thus, a REIT property usually does not generate deductions in excess of income, other than when it is newly constructed or renovated and has not yet "stabilized" its tenant base. Yet, even though section 470 would rarely operate to suspend losses for a REIT property, an SEC-registered REIT would be compelled to undertake substantial verification procedures to document each property's profitability. Public REITs already are expending millions to comply with section 404 of the Sarbanes-Oxley Act, and to layer on top of this extensive review procedure additional inquiries for the rare instance when a property generates a net loss that cannot even be allocated to a REIT shareholder is excessive, unnecessary, and unproductive both for the REIT and the IRS. This waste of resources is particularly acute with respect to transactions entered into in 2004, for which REITs are currently preparing SEC filings.

3. Proposal

For these reasons, NAREIT respectfully requests that the TTCA clarify that, for purposes of sections 470 and 168, a REIT is not pass-thru entity within the context of section 168(h)(6)(E).

NAREIT thanks the Committee for the opportunity to comment on this important legislation.

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11 *Id.* § 561.
12 Id. § 857(a)(1).