ALSTON+BIRD LLP

REIT TAX ADVISORY

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2008 REIT Tax Developments – The Year in Review

While 2008 was a challenging year for REITs and the capital markets generally, it was a significant year for REIT tax developments. Two pieces of legislation contained favorable amendments to the REIT provisions in the Internal Revenue Code: the "Farm Bill," creating various special provisions for timber REITs and the "Housing Bill," including most of the RIDEA provisions championed by NAREIT. In addition, the IRS issued guidance on a number of issues, including those created by accounting rules for purchase price allocations, as well as guidance on cash-option dividends that takes into account the crippled state of the capital markets and REITs' corresponding needs to preserve cash. These developments are summarized below.

Legislation

Farm Bill

In May, the House and Senate passed the Food, Conservation, and Energy Act of 2008 (the "Farm Bill") and overrode President Bush's veto. The Farm Bill included several provisions of interest to timber REITs (including many, but not all, of the provisions in the TREE Act that was introduced in the House in 2007).

- The Farm Bill provides that gains under sections 631(a) (provided that the timber is cut by a taxable REIT subsidiary ("TRS")) and 631(b) from sales of timber is qualifying income for purposes of the 75% and 95% gross income tests, without regard to how long the timber was held. Any such sales would not be subject to the prohibited transaction tax. These provisions codify the existing private letter ruling conclusions with respect to section 631(b) gains and sales with retained economic interests of property not held for more than one year, and extend such positions to section 631(a) gains, short-term sales without retained economic interests and self-cutting of timber not held for more than one year.
- The Farm Bill treats mineral royalty income of a "timber real estate investment trust" as qualifying income for purposes of the 95% gross income test. A "timber real estate investment trust" is a REIT in which more than 50% of its assets (by value) consists of real property held in connection with a trade or business of producing timber.
- The Farm Bill permits a timber REIT to own TRS securities representing up to 25% of the value of the REIT's assets (up from 20%).

- The Farm Bill shortens the prohibited transaction tax safe harbor to two years for certain conservation sales of timber property.

For revenue reasons, the Farm Bill's REIT provisions generally apply only in 2009 REIT taxable years. The TRS securities limit and the prohibited transaction safe harbor were revisited in the Housing Bill.

Housing Bill

On July 30, 2008, President Bush signed into law the Housing and Economic Recovery Act of 2008 (the "Housing Bill"), which includes most of the REIT provisions previously proposed in the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA). The new provisions relate to (i) foreign currency issues, (ii) limitations on holding taxable REIT subsidiary securities, (iii) prohibited transactions and (iv) special rules for health care and lodging facilities. Unless otherwise indicated, all changes apply in REIT taxable years beginning after July 30, 2008.

Foreign Currency Issues

The Housing Bill contains a number of provisions relating to foreign currency gains (generally gains that are attributable to exchange rate changes involving a currency other than the REIT's functional currency, i.e., a "nonfunctional currency").

In addition, it gives Treasury general authority to determine that other types of income may be disregarded in applying the 75% gross income test and/or the 95% gross income test, or may be treated as qualifying income in applying the 75% gross income test and/or the 95% gross income test. This general delegation of authority should increase the IRS's authority to address various GAAP/tax discrepancies (see from controlled foreign corporations rulings summarized below) and is expected to lead to confirmation that subpart F inclusions from controlled foreign corporations are qualifying income for purposes of the 95% gross income test.

REIT Gross Income Tests and Foreign Currency Gains

Many REITs have increased their interest in foreign investments in recent years, but uncertainty regarding the treatment of foreign currency gains under the REIT gross income tests has complicated the structuring of foreign investments. The IRS has issued guidance in recent years, treating certain gains under section 988 as qualifying income (Rev. Rul. 2007-33) and providing general guidance on the treatment of section 987 branch remittances (Notice 2007-42). The Housing Bill provides a more comprehensive framework for applying the gross income tests to foreign currency gains.

- ***Disregarding Foreign Currency Gains***

Contrary to the recent IRS guidance, under the Housing Bill, foreign currency gains generally are not qualifying income for purposes of the gross income tests. Instead, the Housing Bill provides that certain foreign currency gains are disregarded (not included in either the numerator or the denominator) in applying the gross income tests. Foreign currency gains that are not excluded are treated as nonqualifying income.

– "Real estate foreign exchange gain" is excluded in applying the 75% gross income test and the 95% gross income test. Real estate foreign exchange gain includes section 988(b)(1) foreign currency gains attributable to (i) items of qualifying income or gain under the 75% gross income test (e.g., foreign currency gains arising from changes in currency rates between the time mortgage interest or rents from real property accrue and are received), (ii) the acquisition or ownership of obligations secured by mortgages on real property or on interests in real property (e.g., foreign currency gains arising upon receipt of principal on, or disposition of, a mortgage loan denominated in a nonfunctional currency) and (iii) becoming or being an obligor under obligations secured by mortgages on real property or on interests in real property and denominated in a nonfunctional currency (e.g., foreign currency gains arising with respect to payments on a qualifying REIT liability denominated in a nonfunctional currency). Real estate foreign exchange gain also includes section 987 gain attributable to a qualified business unit (a "QBU," generally a branch with a different functional currency) if the QBU satisfies the 75% gross income test for the year and the 75% asset test at the close of each quarter. The Secretary of the Treasury is authorized to treat additional foreign currency gains as real estate foreign exchange gain. Treasury is also expected to provide guidance on the treatment of section 987 gains that are not treated as real estate foreign exchange gains.

– "Passive foreign exchange gain" is excluded in applying the 95% gross income test but is treated as nonqualifying income for purposes of the 75% gross income test (except to the extent of also qualifying as real estate foreign exchange gain). Passive foreign exchange gain includes section 988(b)(1) foreign currency gains attributable to (i) items of qualifying income or gain under the 95% gross income test, (ii) the acquisition or ownership of debt obligations and (iii) becoming or being an obligor under debt obligations. Treasury is authorized to treat additional foreign currency gains as passive foreign exchange gain.

Foreign currency gain will not be treated as real estate foreign exchange gain or passive foreign exchange gain and, accordingly, will be treated as nonqualifying income for purposes of the 75% and 95% gross income tests to the extent it is derived from dealing in, or substantial and regular trading in, securities. These provisions apply to gains and items of income recognized after July 30, 2008.

• ***Hedging Income***

The Housing Bill makes two changes to the treatment of hedging income.

– Income from properly identified transactions that hedge indebtedness incurred or to be incurred to acquire or carry real estate assets has been treated as nonqualifying income for purposes of the 75% gross income test but is disregarded for purposes of the 95% gross income test. Under the Housing Bill, such income is also disregarded for purposes of the 75% gross income test.

– The Housing Bill also excludes hedging income for purposes of the 75% and 95% gross income tests if the hedge is properly identified and is entered into to manage

currency risk with respect to income that qualifies under the 75% gross income test or the 95% gross income test (or assets that generate such income).

These provisions apply to gains and items of income recognized after July 30, 2008.

- ***Foreclosure Property***

Foreign currency gains attributable to income from foreclosure property (that qualifies for purposes of the 75% and 95% gross income test) would be treated as permitted income from foreclosure property for purposes of the 75% and 95% gross income tests and the rules for taxation of income from foreclosure property. This provision applies to transactions entered into after July 30, 2008.

Currency Effects on Asset Tests

Two of the provisions in the Housing Bill address two currency-related asset test issues.

- ***Valuation Changes Attributable to Exchange Rates***

Changes in foreign currency exchange rates used to value a foreign asset will not cause a REIT to fail the REIT asset tests.

- **Foreign Currency Treated as Cash**

Cash is a qualifying asset for purposes of the 75% asset test. The Housing Bill treats foreign currency as cash for these purposes if it is the functional currency of the REIT or a QBU of the REIT, is held in the normal course of generating qualifying income or is directly related to acquiring or holding qualifying assets and is not held in connection with a trade of business of trading or dealing in securities.

Foreign Currency Gains/Losses Attributable to Prohibited Transactions

Under the Housing Bill, foreign currency gains and losses attributable to prohibited transactions are taken into account in determining the tax on prohibited transactions. This provision applies to sales made after July 30, 2008.

Taxable REIT Securities

The Housing Bill expands the limitation on holdings of securities of TRSs from 20% to 25% of a REIT's gross assets.

Prohibited Transactions

Gains on dealer sales are subject to a 100% prohibited transaction tax. Dealer status generally must be determined based on all of the facts and circumstances. The Code, however, provides a multi-factor safe harbor, with sales that qualify for the safe harbor avoiding the prohibited transaction tax. The safe harbor has been criticized as overly restrictive. The Housing Bill modifies the safe harbor.

Holding Period

The Housing Bill reduces the minimum holding period in the safe harbor from four years to two years.

Maximum Sales

For REITs that cannot satisfy the seven sales limit, the Housing Bill changes the alternative limit of 10% of the adjusted basis of the REIT's assets to the higher of 10% of the fair market value or adjusted basis of the REIT's assets.

Treatment of Safe Harbor Gains

The Housing Bill clarifies that gain from sales qualifying for the safe harbor is not treated as capital gain unless it would otherwise qualify as capital gain.

Health Care and Lodging Facilities

Health Care Facilities Leased to a TRS

Rents from a lease of a qualified lodging facility to a TRS generally avoid the related party rent prohibition. The Housing Bill also permits qualified health care properties to be leased to a TRS as long as they are managed by an eligible independent contractor.

Operation of Health Care Facilities and Lodging Facilities

The Housing Bill does not treat a TRS as operating or managing a qualified health care or lodging facility merely because the TRS holds a license or permit to do so. It also permits the TRS to be the employer of employees at health care and lodging facilities outside the United States, as long as they are subject to the daily supervision and direction of an eligible independent contractor. In addition, the operator may be treated as an independent contractor even if the TRS bears the operating expenses or receives the revenues from the lodging or health care facility, net of operating expenses and fees payable to the operator.

IRS Guidance

Cash-Option Dividends

REITs are required to distribute 90% of their REIT taxable income each year and historically have relied on the capital markets to provide funds for growth and debt repayments. The recent collapse of the capital markets not only has made it more difficult for REITs to raise capital directly but has also made it more difficult for REITs to sell properties to raise cash. Given the uncertainty regarding when the capital markets may turn around and the impending debt maturities facing most REITs, REITs have focused on cash preservation strategies. Many public REITs have announced suspensions or substantial reductions in their distribution plans. REITs with taxable income, however, must satisfy their distribution requirements. One strategy for satisfying distribution requirements while preserving cash is to use cash-option dividends in which shareholders elect whether to receive distributions of cash or stock, with caps on the amount of cash that will be distributed regardless of the shareholders' choices.

The IRS has issued private letter rulings to REITs confirming that cash-option dividends would be treated as dividends for purposes of the REIT rules (with taxpayers receiving stock treated as receiving the amount of cash they could have elected to receive), provided that at least 20%

of aggregate distributions was in cash. PLR 200817031, PLR 200832009, PLR 200850022, and PLR 200852020. NAREIT requested more general guidance that would eliminate the need for private letter rulings and a 5% minimum cash requirement. The IRS issued Revenue Procedure 2008-68, providing general relief for 2008 and 2009.

Under Rev. Proc. 2008-68, for 2008 and 2009 REIT taxable years, the IRS will treat cash-option dividends as dividends for REIT distribution and dividends paid deduction purposes equal to the amount of cash that could have been received, if various requirements are satisfied:

- The stock of the REIT must be publicly traded on an established securities market in the United States. NAREIT had requested that the relief also apply to SEC-registered non-listed REITs. The IRS chose not to extend relief to such REITs, presumably due to uncertainty about the value of shares of non-listed REITs.
- Each shareholder may elect to receive its entire distribution in either cash or stock, subject to a cash limitation on the aggregate amount of cash distributed of not less than 10% of the aggregate distribution.
- If too many shareholders elect to receive cash, each such shareholder will receive a pro rata (based on relative distribution entitlements) portion of the available cash and will receive the balance of their distributions in stock.
- The shares must be valued as close as practicable to the payment date and must be based upon a "formula utilizing market prices that is designed to equate in value the number of shares to be received with the amount of money that could have been received."
- A REIT dividend reinvestment plan may apply only to shareholders making the cash election. This prevents a shareholder from electing the stock option and getting a DRIP discount.

Lease Rights

A REIT had an interest in a joint venture partnership that acquired all of a lessor's rights (but not obligations) in leases of land and rooftops on which lessees had installed communications equipment. The IRS concluded that the rights acquired by the joint venture were interests in real property and real property assets and that payments from the lessees would constitute rents from real property. PLR 200831020.

Related Party Rents

A partnership in which a REIT held an indirect interest leased property to a corporation owned by an indirect partner in the partnership. The IRS determined that the applicable attribution rules did not cause the rents to be treated as related party rents for purposes of section 856(d)(2)(3). PLR 200842010.

Temporary Housing Units Not Lodging Facilities

Rental of temporary housing units was treated as generating rents from real property. The average length of stay (which was redacted) and low level of services were more consistent with rental of property than provision of a lodging facility service. PLR 200840028.

Section 162(m) Inapplicable to Compensation for Operating Partnership Employees

The IRS addressed application of the section 162(m) limitations on deduction of compensation to "covered employees" of a REIT who were shared with the REIT's operating partnership. Equity securities of both the REIT and the operating partnership were registered with the SEC. The IRS concluded that the section 162(m) deduction limitation (which, by its term, applies only to corporations) was inapplicable to compensation paid by the REIT or the operating partnership for services provided to the REIT's operating partnership and to the REIT's distributive share of the operating partnership's compensation expenses for the operating partnership's employees. PLR 200837024.

Prohibited Transaction Tax Safe Harbor

Application of Housing Bill Prohibited Transaction Tax Safe Harbor in 2008

Taking into account the possibility that a REIT will have sold properties in its 2008 taxable year, both after and on or before July 30, 2008, prior to the effective date of the Housing Bill's 10% fair market value option under the prohibited transaction tax safe harbor, the IRS indicated that the safe harbor will apply if the 10% adjusted basis test is satisfied through July 30, 2008, and the 10% fair market value test is satisfied for the entire 2008 taxable year. Rev. Proc. 2008-69.

Like Kind Exchange Tacked Holding Period Counted for Prohibited Transaction Tax Safe Harbor

The IRS ruled that the holding period of property acquired in a like kind exchange for property and cash includes the holding period of the relinquished property for purposes of the prohibited transaction tax safe harbor holding period requirement. PLR 200824018.

Eligible Independent Contractor's Active Trade or Business

The IRS concluded that a hotel management company owned by the REIT's Chairman and its President/CEO, each of whom also owned REIT stock and operating partnership units, qualified to be treated as an eligible independent contractor. The issue addressed in the ruling was whether the management company was actively engaged in the trade or business of operating qualified lodging facilities for persons unrelated to the REIT and the TRS at the time it entered into management agreements with the TRS. The management company managed three unrelated hotels when it signed the first management agreement with the TRS and two when it signed the second management agreement with the TRS. The management company had a history of hotel operations and continued to seek management contracts. The management company manages and operates hotels through its own employees. The IRS looked to regulation section 1.355-3(b)(2)(iii) for guidance in determining whether a taxpayer is actively engaged in a trade or business, which excludes activities of independent contractors. PLR 200825034.

Generation of Electricity for Tenants

A REIT proposed to install an electrical generating unit at one of its properties and to supply electricity and steam to tenants. An independent contractor would manage electricity generation and maintain the generator. The REIT represented that providing electricity and steam is a

customary service provided in local commercial office buildings. The IRS concluded that the generation and furnishing of electricity and steam to tenants would not taint rents paid by tenants of the property. PLR 200828025.

TRS Qualification

TRS Ownership of Stock of Corporations that Operate Lodging Facilities

The IRS ruled that a TRS may invest in stock (less than 35%) of public and private corporations that own, operate or manage lodging facilities and casinos associated with lodging facilities, or issue franchises for operating lodging facilities, without losing its qualification as a TRS. Such investments would not violate the definitional requirement that a TRS not directly or indirectly operate or manage a lodging facility, or directly or indirectly provide any other person rights to any brand name under which a lodging facility is operated. The IRS concluded that it would not look through investee corporations in which the TRS owned less than 35% of the stock. PLR 200815026.

TRS Ownership of Health Care Facilities

TRSs owned interests in health care facilities. The health care facilities were operated by independent contractors pursuant to management contracts that barred the TRSs from any involvement in the operation of the facilities. While a TRS cannot directly or indirectly operate or manage a health care facility, there is no statutory prohibition on ownership of an interest in a health care facility. Accordingly, mere ownership of interests in the health care facilities did not prevent the TRSs from qualifying as TRSs. PLR 200813003.

Independent Living Facilities Not Health Care Facilities

A REIT proposed to acquire independent living facilities and have its TRS provide certain services. Because a TRS cannot directly or indirectly operate or manage a health care facility, the REIT requested a ruling confirming that the independent living facilities would not be considered health care facilities. Section 856(e)(6)(D)(ii) defines a health care facility as a "hospital, nursing facility, assisted living facility, congregate care facility, qualified continuing care facility (as defined in section 7872(g)(4)), or other licensed facility which extends medical or nursing or ancillary services to patients and which, immediately before the termination, expiration, default, or breach of the lease of or mortgage secured by such facility, was operated by a provider of such services which was eligible for participation in the medicare program under title XVIII of the Social Security Act with respect to such facility." Services provided at the independent living facilities will not include assistance with activities of daily living, such as management of medications, or any medical or nursing services. The facilities will not be licensed or participate in the medicare program. The IRS concluded that the independent living facilities were not health care facilities and rents from tenants will not be treated as other than rents from real property. A TRS also is not permitted to operate a lodging facility, so it was implicit that the independent living facilities also were not lodging facilities. PLR 200813005.

Goodwill

GAAP Goodwill

In connection with a REIT's acquisition of the stock of a corporation that owned a portfolio of widely known resort hotels, a portion of the purchase price was allocated to trade names and brand names (under which the resorts operate) and goodwill under GAAP rules that allocate purchase price in excess of replacement cost to intangibles. These "real estate intangibles" were closely related to, and associated with, particular unique, one-of-a-kind resorts. The REIT represented, among other things, that if the acquisition had been structured as an asset purchase, the amount allocable under GAAP to intangibles would have been included in the basis of the land and buildings for tax purposes. The REIT 75% asset test is based on "total assets," which is defined in regulation section 1.856-2(d)(3) to mean gross assets determined in accordance with GAAP. The IRS stated that an asset other than physical real property will qualify as real property or interests in real property only if it is inextricably tied or connected to the real estate. The IRS concluded that the real estate intangibles qualified as real estate assets and that any rents attributable to the real estate intangibles qualified as rents from real property. PLR 200813009.

Gain on Sale Allocable to Goodwill

In connection with the acquisition and liquidation of a publicly traded REIT that owned community and neighborhood shopping centers, the acquired REIT was treated as having sold all of its assets. Application of section 1060 to allocate the purchase price between the assets of the acquired REIT would result in allocation of some of the purchase price to goodwill. If gain from sale of goodwill were not treated as qualifying income for purposes of the 75% and 95% gross income tests, the acquired REIT would not qualify as a REIT in its final taxable year. The goodwill, however, was integrally related to the REIT's trade or business assets. Accordingly, the IRS concluded that gain allocated to goodwill that relates to trade or business assets will be treated as qualifying income in proportion to gain from the sale of such assets that constitutes qualifying income. PLR 200823014.

Foreign Currency Issues

Functional Currency of Subsidiary REIT

The IRS granted several subsidiary REITs permission to use a currency other than the U.S. dollar as their functional currency. Prior to the Housing Bill's new rules for treatment of foreign currency gains for purposes of the REIT gross income tests, one strategy to avoid such gains was to conduct non-U.S. activities through a REIT that had the same functional currency as its business environment. Under regulations section 1.985-1(b)(1)(iii), a REIT, as a U.S. entity that is classified as a corporation for tax purposes, is required to obtain an IRS ruling to use a currency other than the U.S. dollar as its functional currency. PLR 200821020.

Foreign Currency Gains

Prior to enactment of the Housing Bill, the IRS ruled that section 988 foreign currency gains with respect to foreign currency-denominated obligations incurred by a REIT to acquire assets

that produced qualifying income would be treated as qualifying income for purposes of the 75% and 95% gross income tests. Revenue Ruling 2007-33 had treated section 988 gains with respect to qualifying rents and interest income as qualifying income, but had not addressed section 988 gains with respect to REIT liabilities. PLR 200808024.

Liquidating Distributions to Non-U.S. Shareholders

Consistent with the IRS position in Notice 2007-55, AM 2008-003 expands upon the treatment of liquidating distributions from REITs to non-U.S. shareholders:

- Distributions from publicly traded REITs to non-U.S. shareholders that have not owned more than 5% of the publicly traded stock during the applicable testing period are not subject to U.S. tax. The IRS had considered, and may still be considering, subjecting such taxes to ordinary dividend withholding taxes but acknowledges doubts about its ability to apply section 857(b)(3)(F) to liquidating distributions.
- Distributions from publicly traded REITs to non-U.S. shareholders that have owned more than 5% of the publicly traded stock during the applicable testing period are subject to U.S. tax on the portion of the distributions that is attributable to REIT gain from the disposition of U.S. real property interests.

"Sham" Consent Dividends

The IRS examined a structured transaction in which an international organization that is not subject to U.S. tax on dividends would invest in a bank's captive REIT and agree to receive consent dividends that greatly exceed actual distributions the investor would ever receive unless it continued to hold the stock until the REIT was liquidated 60 years out, an occurrence the IRS considered unlikely due to puts and calls that could be exercised 15 years out. The IRS determined that the consent dividends were shams, that the consent dividends were preferential dividends, that preferential dividends are not deductible and do not satisfy REIT distribution requirements, and, accordingly, that the REIT did not qualify to be taxed as a REIT. CCA 200842039.

Extensions of Time To Make Elections

As usual, there were a number of rulings granting taxpayers extensions of time to make various REIT-related tax elections:

- Extension to file REIT election – PLR 200842020.
- Extension to file TRS election – PLR 200801005, PLR 200805002, PLR 200805017, PLR 200817025, PLR 200827032, PLR 200835004 (REIT had made a TRS election for a prior year in which the REIT expected to, but did not make a REIT election, rendering that TRS election ineffective).
- Extension for nonprofit corporation to make deemed sale election under regulations section 1.337(d)-7(c)(1) in connection with a contribution of assets (with net built-in gain) to its subsidiary REIT - PLR 200835008.
- Extensions to file entity classification election (as corporation, rather than erroneous disregarded entity election actually filed) and TRS election – PLR 200824006.

- Extension to elect to treat January dividends as throw-back dividends under regulations section 1.858-1(b) – PLR 200826015.
- Extension to file consent dividend election (to increase amount of consent dividend elected in timely filed election after discovering error in calculation of REIT taxable income) – PLR 200852021.

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