

REIT Alert

An informational newsletter from Goodwin Procter's Real Estate Capital Markets Group

New Law Liberalizes REIT Provisions

Prohibited Transactions Tax Safe Harbor Holding Period Reduced to Two Years

Yesterday President Bush signed into law the Housing and Economic Recovery Act of 2008 (the "Act"). The Act makes several beneficial changes to the REIT rules, incorporating most of the provisions contained in the NAREIT-sponsored "REIT Investment Diversification and Empowerment Act" that was first proposed in 2007.

The Prohibited Transactions Safe Harbor Holding Period

For many REITs, the most significant provision in the Act shortens the prohibited transactions safe harbor holding period from four years to two. Unless the safe harbor applies, a REIT is potentially subject to a tax equal to 100% of the net income derived from a prohibited transaction (*i.e.*, a sale of property held primarily for sale to customers in the ordinary course of business, or "dealer property"). The prohibited transaction safe harbor used to apply to a sale of real property if, among other requirements, (i) the REIT held the property for at least four years for the production of rental income, and (ii) the aggregate expenditures made by the REIT during the four-year period preceding the date of sale that were includible in the basis of the property (*i.e.*, capital expenditures) did not exceed 30% of the net selling price of the property. The Act shortens both the minimum holding period under the safe harbor and the period during which the limit on capital expenditures applies from four years to two. This provides REITs with significantly more flexibility to dispose of properties without risk of the 100% tax being imposed, provided the other requirements of the safe harbor are met.

REITs and other investors in real property should note, however, the safe harbor is an exception to the prohibited transaction tax only. The Act and its legislative history make clear that satisfying the safe harbor requirements does not prevent the property from being treated as dealer property for other purposes of the tax rules, including for purposes of treating the gain from the sale of the property as ordinary income rather than capital gain or as unrelated business taxable income for tax-exempt investors, including pension plan shareholders in a pension-held REIT.

It has yet to be seen what impact the changes to the safe harbor may have on the practice of REITs making sales outside the safe harbor. The new safe harbor rules apply to sales made on or after July 31, 2008.

Other Modifications of the REIT Income and Asset Tests and Prohibited Transactions Safe Harbor

The Act liberalizes certain other REIT provisions, effective for tax years beginning after July 30, 2008, except as otherwise noted below. These changes include:

- An additional requirement for a sale to qualify for the prohibited transactions safe harbor was that the REIT must not have made more than seven sales of property during the applicable tax year, *or*, that the aggregate tax bases of the properties sold during the taxable year must not have exceeded 10% of the aggregate tax bases of all of the assets of the REIT as of the beginning of the taxable year. The Act changes the 10% limitation so that a REIT can measure its sales based on *either* tax basis *or* fair market value, at the REIT's annual election. This change also applies to sales made on or after July 31, 2008, although IRS guidance will be required to implement this change for 2008.
- The Act increases the REIT asset test limitation with respect to securities of taxable REIT subsidiaries ("TRS") from 20% to 25% of the REIT's assets.
- The Act extends the "related party rent" exception that permits leases between REITs and their TRSs for lodging facilities to qualify as "rents from real property" to cover healthcare facilities. Thus, a TRS can rent a healthcare facility from its parent REIT without disqualifying the rents paid to the parent REIT for purposes of the 75% and 95% income tests, provided that the healthcare facility is managed and operated by an independent contractor and not the TRS itself. This change conforms the treatment of healthcare facilities to lodging facilities.
- The Act broadens the REIT income tests with respect to foreign currency exchange gain. Under existing IRS guidance, certain foreign currency gain was treated as qualified income in certain circumstances. Effective July 31, 2008, certain foreign currency gain attributable to real estate income, real estate assets or to certain indebtedness attributable to the REIT's real estate assets is excluded from the 75% and 95% income tests, and other passive foreign currency gain is excluded from the 95% income test.
- Effective July 31, 2008, certain hedging income that used to be excluded from the 95% income test only is also excluded from the 75% income test, and the exclusion is expanded to apply to certain transactions entered into primarily to manage the risk or currency fluctuations with respect to items of qualifying income under the 75% or 95% income tests (or property that generates such income or gain).
- Foreign currency is now eligible to be treated as "cash" for purposes of the REIT asset tests, but only in certain limited circumstances.
- The Treasury Department is now granted authority to issue guidance providing that other items of income not expressly provided for in the REIT

rules either constitute qualifying income for purposes of one or both of the REIT 75% and 95% income tests or are excluded from income for purposes of one or both of these tests. We anticipate that the IRS will use this provision to issue guidance on Subpart F income and income derived from an investment in a passive foreign investment company.

If you would like additional information about the issues addressed in this REIT Alert, please contact:

Edward L. Glazer	eglazer@goodwinprocter.com	617.570.1170
Mark D. Kirshenbaum	mkirshenbaum@goodwinprocter.com	617.570.1305
Gilbert G. Menna	gmenna@goodwinprocter.com	617.570.1433
H. Neal Sandford	nsandford@goodwinprocter.com	617.570.1632
Ettore A. Santucci	esantucci@goodwinprocter.com	617.570.1531
Karen F. Turk	kturk@goodwinprocter.com	617.570.1097

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