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TRENDS IN REAL ESTATE AND TITLE INSURANCE

Job Law Provides Relief to REITS

Under the American Jobs Creation Act of 2004, minor foot faults need no longer jeopardize tax status.

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THE AMERICAN Jobs Creation Act of 2004 (Jobs Act), enacted on Oct. 22, 2004, amended certain rules relating to real estate investment trusts (REITs), which, among other things provided relief to REITs for minor foot faults that could jeopardize a REIT's tax status.

The following is a non-exhaustive discussion of some of the significant changes affecting REITs in the Jobs Act.

In general, a REIT may not own more than 10 percent by vote or value of any one issuer's securities (the "10 Percent Value Test"). Failure to satisfy the 10 Percent Value Test at the end of any quarter may result in a failure to qualify as a REIT.

Securities of an issuer that qualify for the "straight debt" safe harbor (as described below) are not subject to testing under the 10 Percent Value Test.

The Straight Debt Safe Harbor

As defined in Subchapter S, "straight debt" is any written, unconditional promise to pay on demand or on a specified date a fixed sum of money if the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors, and the debt is not convertible into stock.

Prior to the enactment of the Jobs Act, "straight debt" would qualify for the safe harbor only if: (i) the issuer was an individual; (ii) the only securities of the issuer held by the REIT and any taxable REIT subsidiary (a "TRS") of the REIT constituted "straight debt;" or (iii) the issuer was a partnership in which the REIT owned at least a 20 percent profits interest. As a result, a REIT could run afoul of these rules in the conduct of its ordinary business operations.

For example, a loan by a REIT to a tenant for leasehold improvements, if the statute were read literally, could result in disqualification of the REIT if the loan represented more than 10 percent of the tenant's outstanding securities. The Jobs Act provides for significant changes to these rules that reflect the realities of REIT operations, and that will provide more flexibility for REITs to make loans, and structure loans and other debt instruments, with features that were not permissible under prior law.

In addition to securities that qualify as "straight debt," the Jobs Act expands the types of securities that are not subject to testing under the 10 Percent Value Test to include:

(i) any loan to an individual or estate;

(ii) any Section 467 rental agreement (other than with certain related persons);

(iii) any obligation to pay rents from real property;

(iv) any security issued by a state, or any political subdivision thereof, the District of Columbia, a foreign government, or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under such security does not depend in whole or part on the profits of any entity not described therein or payments on any obligation issued by such an entity;

(v) any security issued by a REIT; and

(vi) any other arrangement determined by the Secretary.

These provisions provide a REIT with greater flexibility in the conduct of ordinary transactions, which prior to enactment of the Jobs Act may have violated the 10 Percent Value Test. Thus, following enactment of the Jobs Act, a REIT, for example, will not risk REIT disqualification if it makes a loan to a tenant for tenant improvements.

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The Jobs Act also expands the definition of "straight debt" to include debt instruments with the following contingencies:

(i) a contingency that relates to the time of payment of principal or interest and such contingency does not

(A) have more than a de minimis impact on the effective yield to maturity on the issuer's debt instrument and

(B) neither the aggregate issue price nor the aggregate face amount of the issuer's debt instruments held by the REIT exceeds $1 million, and not more than 12 months of unaccrued interest can be required to be prepaid thereunder; or

(ii) a contingency that relates to the time or amount of payment upon a default or the exercise of a prepayment right by the issuer of the debt, but only if such contingency is consistent with customary commercial practice.

Thus, practitioners no longer need to be overly concerned about default interest, prepayment penalties or yield maintenance penalties that are customary in today's lending environment.

In addition to the foregoing revisions, the Jobs Act:

(i) eliminates the rule that required that a REIT own a 20 percent equity interest in a partnership in order to qualify as "straight debt;"

(ii) provides a "look through" rule, for purposes of the 10 Percent Value Test, that provides that a REIT partner's share of partnership assets is based on the REIT's proportionate share of partnership securities other than qualifying debt of the partnership (e.g., "straight debt" and securities that are not subject to the 10 Percent Value Test); and

(iii) provides that a loan by a REIT to an issuer may qualify as "straight debt" provided that the REIT (including any TRS of the REIT) does not own more than a de minimis interest (i.e., the securities do not have an aggregate value greater than 1 percent of the issuer's outstanding securities).

This provision eliminates a trap for the unwary in which a REIT makes an otherwise qualifying loan to a partnership or a joint venture in which it has less than a 20 percent interest.

Finally, certain debt instruments issued by a partnership to a REIT that do not meet the requirements described above are nonetheless not treated as securities for purposes of the 10 Percent Value Test:

(i) to the extent of the REIT's interest as a partner in the partnership; and

(ii) if at least 75 percent of the partnership's gross income (excluding gross income from prohibited transactions) is qualifying income for purposes of the 75 percent gross income test, including, but not limited to, rents, dividends and interest.

This provision allows REITs significant flexibility in structuring investments in partnerships and joint ventures that invest in real property and in which the REIT is a partner without violating technical "straight debt" requirements.

Under the … Jobs Act, if a REIT fails to satisfy one or more requirements for REIT qualification other than the gross income tests and asset tests due to reasonable cause and not willful neglect, the REIT may continue to qualify … provided that it pays a penalty tax of $50,000 for each such failure.

The provisions relating to the "straight debt" safe harbor are generally effective retroactively to tax years beginning after Dec. 31, 2000. However, the rule for determining a REIT partner's share of partnership securities for purposes of the 10 Percent Value Test will be effective for tax years beginning after Oct. 22, 2004.

REIT Requirement Violations

Violations of the REIT Asset Tests. A REIT must meet certain requirements with respect to the assets held by it as of the close of any quarter.

Under prior law, a REIT that failed to cure a violation of the asset tests within 30 days of the close of any quarter risked disqualification as a REIT (even if the REIT was unaware of the violation). Thus, if a REIT formed a C corporation and inadvertently failed to make a TRS election, the REIT could fail to qualify as a REIT.

The Jobs Act provides additional mitigating provisions with respect to a REIT's qualification as a REIT if it inadvertently has more than 5 percent of its total assets in the securities of one issuer or if it holds more than 10 percent (by vote or by value) of the securities of any one issuer.

The Jobs Act provides that if:

(i) the value of the assets causing the REIT to violate the 5 percent or 10 percent tests does not exceed the lesser of

(A) 1 percent of the value of its assets at the end of the quarter in which the violation occurs, or

(B) $10 million, and

(ii) if the violation is cured by disposing of such assets within a designated period,

then the REIT will not lose its qualification as a REIT.

For violations that exceed the lesser of the 1 percent or $10 million threshold, the REIT still may avoid disqualification as a REIT provided:

(i) the failure to satisfy the 5 percent or 10 percent tests was due to reasonable cause and not to willful neglect;

(ii) the REIT files a schedule with the IRS describing the assets causing the violation;

(iii) the violation is cured by disposing of assets within a designated period; and

(iv) the REIT pays a "penalty tax."

The penalty tax is equal to the greater of (A) $50,000, or (B) the product derived by multiplying the highest federal corporate income tax rate by the net income generated by the non-qualifying assets during the period of the failure.

The "reasonable cause" exception also applies if less than 75 percent of the REIT's total assets are represented by real estate assets or if more than 20 percent of the REIT's total assets are represented by the securities of one or more taxable REIT subsidiaries.

This provision will be effective for tax years beginning after Oct. 22, 2004.

Violations of the REIT Gross Income Tests. A REIT must meet the 75 percent

gross income test and the 95 percent gross income test with respect to the sources of its income on an annual basis.

Under prior law, a REIT that failed to satisfy either or both of the 75 percent gross income test or the 95 percent gross income test could still qualify as a REIT if it was entitled to relief under one of the following provisions:

(i) the REIT's failure to satisfy these tests was due to reasonable cause and not willful neglect;

(ii) the REIT attached a schedule of its income sources to its return; and

(iii) any incorrect information on the schedule was not due to fraud with an intent to evade tax.

The Jobs Act conforms the reporting and reasonable cause standards applicable to the income test to those of the asset tests. Accordingly, the Jobs Act provides that a REIT that fails to meet either or both of the 75 percent gross income test or the 95 percent gross income test may still qualify as a REIT if:

(i) following the REIT's identification of the failure to meet one or both of the gross income tests the REIT files a schedule for such taxable year in accordance with regulations to be prescribed by the Secretary; and

(ii) the REIT's failure to meet the gross income tests was due to reasonable cause and not due to willful neglect.

In addition, the Jobs Act makes an adjustment to the penalty for failure to meet the 95 percent gross income test. Prior to enactment of the Jobs Act, if less than 95 percent of the REIT's gross income was from certain passive sources (e.g., rents, interests and dividends), then the REIT was subject to a penalty tax based on the amount by which 90 percent of its gross income exceeded its gross income from such passive sources.

The Jobs Act changes the formula for calculating this penalty. Under the Jobs Act, if less than 95 percent of the REIT's gross income is from certain passive sources, then the REIT will be subject to a penalty tax based on the amount by which 95 percent of its gross income exceeds its gross income from such passive sources.

Other Violations of REIT Requirements. Under the provisions of the Jobs Act, if a REIT fails to satisfy one or more requirements for REIT qualification other than the gross income tests and asset tests due to reasonable cause and not willful neglect, the REIT may continue to qualify as a REIT provided that it pays a penalty tax of $50,000 for each such failure.

The foregoing relief provisions mitigate inadvertent failures by a REIT to meet REIT requirements that are due to reasonable cause and reduce the risk of disqualification as a REIT for such inadvertent failures.

Pursuant to the Foreign Investment in Real Property Tax Act (FIRPTA), capital gains distributions from a REIT to a foreign investor that were attributable to gain from the sale or exchange of a United States real property interest would be treated as income effectively connected with a U.S. trade or business. Thus, foreign investors would be taxed on such income at the same rates as a U.S. investor (i.e., on a net basis at graduated rates).

Capital gain distributions from a REIT to a foreign investor were generally subject to a 35 percent withholding tax (or lower rate applicable under an income tax treaty).

Foreign Investor Changes

The Jobs Act eliminates the 35 percent withholding tax on any capital gain distribution with respect to any class of stock so long as the REIT's common stock is regularly traded on an established securities market in the U.S. and the foreign investor has not owned more than 5 percent of such class of stock at any time during the taxable year in which the dividend is received. Instead, any capital gain dividend will be treated as an ordinary dividend, subject to withholding at a 30 percent rate (or lower rate applicable under an income tax treaty).

Following this change, foreign investment in REITs should be viewed more favorably by foreign investors who are no longer required to file returns with respect to the receipt of capital gains distributions from REITs. This provision applies to tax years beginning after Oct. 22, 2004.

Hedging Transactions

The Jobs Act clarifies that any income from any qualifying hedging transaction entered into by a REIT (including gain from the sale or disposition of such a transaction) will not constitute gross income for purposes of the 95 percent gross income test (but not for purposes of the 75 percent gross income test).

For this purpose, "hedging transaction" means any transaction entered into by the REIT in the normal course of its trade or business to manage the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred by the REIT to acquire or carry real estate assets.

A REIT must clearly identify on its books and records any hedging transaction before the close of the day on which it is acquired, originated or entered into. This provision applies to tax years beginning after Oct. 22, 2004.

Other Provisions

For purposes of the 75 percent and 95 percent income tests, the Jobs Act clarifies the rules regarding the testing dates for determining whether 90 percent of leased space at a REIT's property is leased to unrelated persons and whether such rent paid by a REIT's TRS is substantially comparable to rents paid by unrelated tenants for comparable space.

The Jobs Act also simplifies prior law by eliminating from the definition of "redetermined rents" the exclusion for amounts received by a REIT for services customarily furnished or rendered by a TRS in connection with the rental of real property.

In conclusion, this discussion highlights the principal provisions of the Jobs Act, which implement significant changes that permit REITs to operate more flexibly within the realities of the marketplace.

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