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Management Alert

Housing and Economic Recovery Act of 2008 Adds New REIT-Related Provisions

The Housing and Economic Recovery Act of 2008 (the Act), which was signed into law by President Bush on July 30, 2008, includes a number of provisions that affect Real Estate Investment Trusts (REITs).[1]

Certain foreign currency-related gains excluded from gross income for purposes of REIT gross income tests (new subsection (n) of IRC Section 856). Foreign currency-related gain that constitutes "real estate foreign exchange gain" (REFEG) is excluded from gross income for purposes of both the 75% and 95% gross income tests, whereas foreign currency-related gain that constitutes "passive foreign exchange gain" (PFEG) (and that does not otherwise constitute REFEG) is excluded from gross income only for purposes of the 95% gross income test.[2] This provision changes the result of Rev. Rul. 2007-33 (by excluding foreign currency-related gain, rather than treating such gain as "qualifying income") and supersedes Notice 2007-42 (for remittances from a QBU that uses functional currency other than the U.S. dollar). However, be aware that, except as described below, foreign currency gain derived from dealing, or engaging in substantial and regular trading, in securities (as defined in IRC Section 475(c)(2)) (Securities Trading Activity) will not constitute qualifying income for either gross income test. This provision applies to gains and other income recognized after July 30, 2008.

Certain "hedging transaction" income excludable from gross income for purposes of REIT gross income tests (IRC Section 856(c)(5)(G) amended). "Hedging transaction" income that is excludable for purposes of the 95% gross income test (generally, income from a transaction that hedges indebtedness incurred

[1] Except as otherwise provided below, these provisions are effective for taxable years beginning after the Act's enactment date (i.e., July 30, 2008).

[2] REFEG generally includes "foreign currency gain" (as defined in IRC Section 988(b)(1)) that is attributable to: (A) income/gain that otherwise constitutes "qualifying income" for purposes of the 75% gross income test; and (B) acquiring, owning or becoming (or being) the obligor under mortgages on real property (or interests in real property). REFEG also includes section 987 gain attributable to a REIT's "qualified business unit" (QBU) if, generally, the QBU meets the 75% gross income test. PFEG generally includes all REFEG, along with foreign currency gain that is attributable to (x) income/gain that otherwise constitutes "qualifying income" for purposes of the 95% gross income test; and (y) acquiring, owning or becoming (or being) the obligor under obligations. The Secretary may also identify other foreign currency gain as either REFEG or PFEG. The Joint Committee on Taxation's Technical Explanation of the Act sets forth four examples which distinguish between REFEG and PFEG.

to acquire or carry real estate assets) will now also be excludable for purposes of the 75% gross income test. In addition, income from a transaction (including gain from termination of such transaction) entered into by a REIT primarily to manage currency fluctuation risk with respect to any income or gain constituting qualifying income for purposes of either gross income test (or any property that generates such income or gain) is excludable from "gross income" for purposes of both gross income tests (but only if such transaction is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may prescribe)). These provisions are effective for transactions entered into after July 30, 2008.

Secretary granted authority as to treatment of other items of income or gain. The Secretary is authorized to treat other items of income or gain either as excludable from gross income or (if not otherwise statutorily excluded from gross income) as qualifying income for purposes of gross income tests. This provision is effective for gains and other income recognized after July 30, 2008.

Modifications to asset tests provisions. A REIT will not fail the asset tests by reason of a discrepancy in its foreign asset values caused solely by foreign exchange rate fluctuations.

Also, foreign currency used by a REIT or its QBU as its "functional currency" (as defined in IRC Section 985(b)) will be treated as "cash" for purposes of the asset tests, but only to the extent such foreign currency (i) is held for use in the normal course of the REIT's or the QBU's activities which give rise to qualifying income under either the 75% or 95% gross income test or are directly related to acquiring or holding assets described in IRC Section 856(c)(4), and (ii) is not held in connection with a Securities Trading Activity.

In addition, the securities of taxable REIT subsidiaries (TRS) may constitute up to 25% (rather than 20%) of the value of a REIT's total assets.

Modification to "prohibited transactions" provision. For sales made after July 30, 2008, the "safe harbor" holding period is shortened to two years (from four years) and a 10%-of-aggregate fair market value alternative test is added (in addition to the 10%-of-aggregate bases test) for qualifying for the safe harbor.

Also, for gains and deductions recognized after July 30, 2008, in determining "net income derived from prohibited transactions," foreign currency gain from prohibited transactions and otherwise allowable "foreign currency loss" (as defined in IRC Section 988(b)(2)) directly connected with prohibited transactions are taken into account in such determination.

Modifications to "foreclosure property" provision. For gains recognized after July 30, 2008, in determining "net income from foreclosure property," foreign currency gain from the sale or other disposition of foreclosure property and not attributable to gross income constituting qualifying income for purposes of the 75% gross income test is taken into account in such determination.

Extending "qualified lodging facility" rental exception to "qualified health care properties" -- Certain TRS activities identified as not "operating or managing". The Act extends the rental exception applicable to qualified lodging facilities to health care facilities. Thus, the rents paid by a TRS to its parent REIT for a "qualified health care property" that is operated by an eligible independent contractor will constitute qualifying rental income for purposes of both gross income tests. Also, a TRS is not considered to be operating or managing a "qualified health care property" or "qualified lodging facility" solely because it (i) directly or indirectly possesses a license, permit, or similar instrument enabling it to do so, or (ii) employs individuals working at such facility or property located outside the U.S., but only if an eligible independent contractor is responsible for the daily supervision and direction of such individuals on behalf of the TRS pursuant to a management agreement or similar service contract.

For more information, please contact the Seyfarth Shaw attorney with whom you work, or any Tax attorney on our website (www.seyfarth.com/Tax).

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