HUNTON& WILLIAMS

CLIENT ALERT

July 2008

REIT Legislative Action: The Housing and Economic Recovery Act of 2008

On July 30, 2008, the President signed into law the Housing and Economic Recovery Act of 2008 (the "Act"). This memorandum discusses the provisions of the Act that directly affect REITs. Except as otherwise noted below, all REIT provisions of the Act apply to taxable years beginning after July 30, 2008.

Prohibited Transaction Tax Safe Harbor

Under current law, REITs are subject to a prohibited transaction tax of 100 percent on the gain from sales of "dealer" property. A safe harbor from the prohibited transaction tax applies if, among other requirements, (1) the REIT's holding period for the property is at least four years and (2) either (a) the REIT does not make more than seven property sales during the taxable year or (b) the aggregate tax bases of all properties sold during the year do not exceed 10 percent of the aggregate tax bases of all of the REIT's properties as of the beginning of the year (the "10 percent test").

The Act shortens the current four-year holding period under the safe harbor to a two-year holding period. The Act also modifies the safe harbor exception by allowing a REIT to elect each year to apply the 10 percent test on either a "fair market value" or "aggregate bases" approach. Thus, the aggregate tax bases of all properties sold during the year must be less than 10 percent of the aggregate tax bases of all of the REIT's properties as of the beginning of the taxable year, or the aggregate fair market value of all properties sold during the year must be less than 10 percent of the aggregate fair market value of all the assets of the REIT as of the beginning of the taxable year.

The provisions relating to the prohibited transactions tax safe harbor apply to sales made after the date of enactment.

Taxable REIT Subsidiary Limit Increase

Currently, a REIT's ownership in taxable REIT subsidiaries ("TRSs") is limited to 20 percent of the value of the REIT's gross assets. The Act increases this percentage limit to 25 percent of the value of the REIT's gross assets.

Health Care Facilities Held by a TRS

Under current law, a TRS generally may engage in any kind of business activity other than the operation or management, directly or indirectly, of a lodging or health care facility. However, a REIT may earn qualifying rental income from a lease of a lodging facility to a TRS as long as the TRS hires an eligible independent contractor to operate such facility. Those types of TRSs are not considered related-party tenants and may be owned 100 percent by the REIT.

The Act expands the TRS exception for lodging facilities to apply to health

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care facilities. Thus, a REIT may earn qualifying income from leasing a health care facility to a TRS that has engaged an eligible independent contractor to operate such facility, even though the REIT owns 100 percent of the TRS. The general prohibition on a TRS directly or indirectly operating or managing a lodging or health care facility remains in effect.

The Act also provides that a TRS will not be considered to operate or manage a qualified health care property or a qualified lodging facility solely because the TRS directly or indirectly possesses a license, permit, or similar instrument enabling it to do so. In addition, the Act provides that a TRS will not be considered to operate or manage a qualified health care property or qualified lodging facility solely because it employs individuals working at such a property or facility located outside of the United States, as long as 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.

Foreign Currency Gain

Foreign currency gain is not explicitly included in the definitions of qualifying income for purposes of the 75 percent and 95 percent gross income tests. The Act excludes "real estate foreign exchange gain" from gross income for purposes of the 75 percent and 95 percent gross income tests and excludes "passive foreign exchange gain" from gross income for purposes of the 95 percent gross income test, but treats such income as nonqualifying income for the 75 percent gross income test.

Real estate foreign exchange gain generally consists of certain foreign currency gain that is attributable to (1) any item of income or gain described in the 75 percent gross income test, (2) the acquisition or ownership of obligations secured by mortgages on real property or on interests in real property, or (3) becoming or being the obligor under obligations secured by mortgages on real property or on interests in real property. Real estate foreign exchange gain also includes (1) certain foreign currency gains attributable to a qualified business unit ("QBU") of a REIT if the QBU itself satisfies the 75 percent gross income test for the taxable year and satisfies the 75 percent asset test at the close of each quarter of the REIT during which it has directly or indirectly held the QBU and (2) any other foreign currency gain as determined by the Secretary of the Treasury.

Passive foreign exchange gain generally includes all real estate foreign exchange gain, as well as certain foreign currency gain that is attributable to (1) any item of income or gain described in the 95 percent gross income test, (2) the acquisition or ownership of obligations, (3) becoming or being the obligor under obligations, and (4) any other foreign currency gain as determined by the Secretary of the Treasury.

Real estate foreign exchange gain and passive foreign exchange gain do not include any foreign currency gain derived from dealing, or engaging in substantial and regular trading, in securities.

The Act also makes several other conforming changes with respect to foreign currency gain, including provisions addressing the treatment of income from hedging foreign currencies. The foreign currency gain provisions generally apply to gain and income recognized after the date of enactment.

Regulatory Authorization

The Act authorizes the Treasury Department to issue guidance that would allow items of income not specifically addressed by the 75 percent or 95 percent gross income tests to be excluded for purposes of computing qualifying gross income under either test, and would allow items of income otherwise not qualifying to be included as qualifying income for either of such tests, in appropriate cases consistent with the purposes of the REIT provisions. This provision applies to gains and income recognized after the date of enactment.

A copy of the Act is available at http://www.house.gov/apps/list/press/financialsvcs_dem/hr3221_bill_text.pdf.

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