LATHAM & WATKINS

Number 734 August 1, 2008

Client Alert

Latham & Watkins
Tax Department

2008 Housing Act Amends US Rules Governing Real Estate Investment Trusts

On July 30, 2008, President Bush signed into law the American Housing Rescue and Foreclosure Prevention Act of 2008 (the Housing Act), which liberalized the tax rules governing real estate investment trusts (REITs). The following is a brief summary of certain provisions of the Housing Act and their anticipated effect.

Amendments Affecting the REIT Gross Income Tests

"The provisions contained in the Housing Act relating to REITs generally apply to taxable years beginning on or after January 1, 2009."

REITs must satisfy various tests regarding the composition of their gross income. In general, a REIT must derive 95 percent of its annual gross income from specified sources such as rents, dividends and interest, and 75 percent of a REIT's annual gross income must be from specified real estate-related sources. The Housing Act alters the application of the income tests in the following ways:

- The Housing Act provides that most real estate-related foreign currency gain is excluded from the computation of the REIT gross income tests (*i.e.*, such gain is excluded from the numerator and the denominator of the REIT gross income test computations). However, foreign currency gain is treated as non-qualifying income if it is derived from substantial and regular trading or dealing in securities. These rules depart from previously issued IRS guidance that treated foreign currency gains as qualifying income under the REIT gross income tests to the extent they were attributable to assets producing qualifying income.
- The Housing Act expands the scope of the hedging exception by providing that the REIT gross income tests will exclude any income from a hedging transaction entered into by the REIT primarily to manage the risk of (1) interest rate changes with respect to borrowings made or to be made to acquire or carry real estate assets, or (2) currency fluctuations with respect to an item of qualifying income under the REIT gross income tests. Prior to this amendment, income from a hedging transaction was treated as nonqualifying income for purposes of the REIT 75 percent gross income test, and only the income from hedging transactions described under number (1) above was excluded from the 95 percent gross income test.
- The Housing Act also explicitly grants the Treasury Department the authority to determine whether an item of income that does not otherwise constitute qualifying income under the 75 percent or 95 percent gross income test may be considered as qualifying income for purposes of such tests or may be excluded from the REIT gross income test computations.

Amendments Affecting the REIT Asset Tests

REITs also must satisfy certain tests regarding the composition of their assets as of the end of each calendar quarter. The Housing Act revises the application of the asset tests in the following ways:

- Previously, not more than 20 percent of a REIT's total assets could be represented by securities of one or more of the REIT's taxable REIT subsidiaries. The Housing Act amends this rule by increasing this limitation to 25 percent.
- The Housing Act clarifies that foreign currency held by qualified business units of a REIT generally will constitute "cash" for purposes of the REIT asset tests if such currency is (1) the functional currency of the qualified business unit, (2) held for use in the normal course of activities giving rise to qualifying income and (3) not held in connection with substantial and regular trading or dealing in securities.
- Under the REIT rules, a REIT that has satisfied the assets tests at the close of any quarter will not lose its status as a REIT for failure to satisfy the asset tests at the end of a later quarter solely by reason of changes in asset values. The Housing Act expressly expands this rule to fluctuations in asset values caused by changes in the foreign currency exchange rate used to value foreign assets.

Amendments Affecting the Prohibited Transaction Safe Harbors

REITs are required to pay a 100 percent tax on any net income from prohibited transactions. Prohibited transactions are, in general, sales or other taxable dispositions of property, other than foreclosure property, held primarily for sale to customers in the ordinary course of business (so called "dealer sales"). The determination of whether property is held primarily for sale to customers in the ordinary course of business normally depends on all of the facts and circumstances surrounding the particular transaction, but the Internal Revenue Code contains a safe harbor applicable to REITs which, if satisfied, prevents a sale of property from being characterized as a prohibited transaction.

Prior to amendment by the Housing Act, this safe harbor generally required that:

- the REIT held the property for at least four years prior to sale;
- the cost of the REIT's capital improvements to the property during the four-year period prior to the property's sale did not exceed 30 percent of the sales price;
- during the taxable year, the REIT did not sell (1) more than seven properties or (2) provided certain other requirements were met, properties with aggregate adjusted basis in excess of 10 percent of the aggregate basis of all the REIT's assets as of the beginning of the taxable year; and
- in the case of land or improvements not acquired through foreclosure, the REIT held the property for the production of rental income for at least four years.

The Housing Act amends this safe harbor test by:

- reducing the four-year periods discussed above to two-years; and
- allowing the REIT to measure the 10 percent limit discussed above using either the tax basis or the fair market value of the property.

Amendments Affecting Healthcare REITs

Unless an exception applies, rent paid by a taxable REIT subsidiary to its parent REIT generally is not considered qualifying income for purposes of the REIT gross income tests. An exception applies in the case of a "qualified lodging facility" leased by a REIT to its taxable REIT subsidiary if the facility is operated on behalf of the taxable REIT subsidiary by an "eligible independent contractor." The Housing Act expands this exception to include "qualified healthcare property" leased by a REIT to its taxable REIT subsidiary and operated on behalf of the taxable REIT subsidiary by an eligible independent contractor, conforming the rules applicable to these two property types. For this purpose, "qualified healthcare properties" generally include hospitals, nursing facilities or similar facilities operated by a service provider that is entitled to participate in the Medicare program.

While a taxable REIT subsidiary may lease a qualified lodging facility or qualified healthcare property from its parent REIT if the facility or property is operated by an eligible independent contractor, a taxable REIT subsidiary may not directly or indirectly operate or manage a lodging facility or health care facility, and such subsidiaries also may not provide rights (*e.g.*, license, franchise, etc.) to any brand name under which any such a facility is operated. The Housing Act clarifies the current law by providing that a taxable REIT subsidiary shall not be deemed to violate these prohibitions where the taxable REIT subsidiary provides rights to a brand name if such rights are held by the taxable REIT subsidiary as a franchisee or licensee and the facility itself is either owned by the taxable REIT subsidiary or leased by the subsidiary from its parent REIT under the rules described previously.

Effective Dates

The provisions contained in the Housing Act relating to REITs generally apply to taxable years beginning on or after January 1, 2009. However, the rules applicable to the REIT gross income tests apply to gains and items of income recognized after July 30, 2008, the date the Housing Act was enacted, and the rules affecting prohibited transactions apply to sales made after such date.

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The foregoing is only a brief summary of the principal REIT-related provisions of the Housing Act and does not address all aspects of the legislation or all possible effects it may have on a REIT or its shareholders. If you have any questions about this *Client Alert* or would like additional information regarding the legislation described herein, please contact Michael Brody, David Kahn, Pardis Zomorodi or Eric Matuszak in our Los Angeles office.

If you have any questions about this *Client Alert*, please contact one of the authors listed below:

Michael J. Brody
Los Angeles

David O. Kahn
Los Angeles

Pardis Zomorodi
Los Angeles

Eric J. Matuszak
Los Angeles

Or any of the following attorneys listed to the right.

Office locations:

Barcelona
Brussels
Chicago
Dubai
Frankfurt
Hamburg
Hong Kong
London
Los Angeles
Madrid
Milan
Moscow
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New Jersey
New York
Northern Virginia
Orange County
Paris
Rome
San Diego
San Francisco
Shanghai
Silicon Valley
Singapore
Tokyo
Washington, D.C.

Barcelona
José Luis Blanco
+34.93.545.5000

Brussels
Howard Rosenblatt
+32.2.788.60.00

Chicago
Robert G. Goldman
+1.312.876.7700

Dubai
Rindala Beydoun
+971.4.704.6300

Frankfurt
Hans-Jürgen Lütt
+49.69.6062.6000

Hamburg
Götz T. Wiese
+49.40.4140.30

Hong Kong
Joseph A. Bevash
+852.2522.7886

London
Daniel Friel
Sean Finn
+44.20.7710.1000

Los Angeles
Laurence J. Stein
+1.213.485.1234

Madrid
José Luis Blanco
+34.91.791.5000

Milan
Fabio Coppola
+39.02.3046.2000

Moscow
Mark M. Banovich
+7.495.785.1234

Munich
Stefan Süss
+49.89.2080.3.8000

New Jersey
David J. McLean
+1.973.639.1234

New York
David S. Raab
+1.212.906.1200

Northern Virginia
Eric L. Bernthal
+1.703.456.1000

Orange County
David W. Barby
+1.714.540.1235

Paris
Christian Nouel
+33.1.40.62.20.00

Rome
Fabio Coppola
+39.02.3046.2000

San Diego
Bruce P. Shepherd
+1.619.236.1234

San Francisco
Scott D. Thompson
+1.415.391.0600

Shanghai
Rowland Cheng
+86.21.6101.6000

Silicon Valley
Joseph M. Yaffe
+1.650.328.4600

Singapore
Mark A. Nelson
+65.6536.1161

Tokyo
Hisao Hirose
+81.3.6212.7800

Washington, D.C.
Nicholas J. DeNovio
+1.202.637.2200