

108TH CONGRESS
1ST SESSION

S. 1568

To amend the Internal Revenue Code of 1986 to simplify certain provisions applicable to real estate investment trusts.

IN THE SENATE OF THE UNITED STATES

AUGUST 1 (legislative day, JULY 21), 2003

Mr. HATCH (for himself, Mr. BREAUX, Mr. SMITH, Mr. LOTT, and Ms. SNOWE) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1986 to simplify certain provisions applicable to real estate investment trusts.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Real Estate Invest-
5 ment Trust Improvement Act of 2003”.

6 **SEC. 2. AMENDMENT OF 1986 CODE.**

7 Except as otherwise expressly provided, whenever in
8 the Act an amendment or repeal is expressed in terms of
9 an amendment to, or repeal of, a section or other provi-
10 sion, the reference shall be considered to be made to a

1 section or other provision of the Internal Revenue Code
2 of 1986.

3 **TITLE I—REIT CORRECTIONS**

4 **SEC. 101. REVISIONS TO REIT ASSET TEST.**

5 (a) EXPANSION OF STRAIGHT DEBT SAFE HAR-
6 BOR.—Section 856 (defining real estate investment trust)
7 is amended—

8 (1) in subsection (c) by striking paragraph (7),
9 and

10 (2) by adding at the end the following new sub-
11 section:

12 “(m) SAFE HARBOR IN APPLYING SUBSECTION
13 (c)(4).—

14 “(1) IN GENERAL.—In applying subclause (III)
15 of subsection (c)(4)(B)(iii), except as otherwise de-
16 termined by the Secretary in regulations, the fol-
17 lowing shall not be considered securities held by the
18 trust:

19 “(A) Straight debt securities of an issuer
20 which meet the requirements of paragraph (2).

21 “(B) Any loan to an individual or an es-
22 tate.

23 “(C) Any section 467 rental agreement (as
24 defined in section 467(d)), other than with a
25 person described in subsection (d)(2)(B).

1 “(D) Any obligation to pay rents from real
2 property (as defined in subsection (d)(1)).

3 “(E) Any security issued by a State or any
4 political subdivision thereof, the District of Co-
5 lumbia, a foreign government or any political
6 subdivision thereof, or the Commonwealth of
7 Puerto Rico, but only if the determination of
8 any payment received or accrued under such se-
9 curity does not depend in whole or in part on
10 the profits of any entity not described in this
11 subparagraph or payments on any obligation
12 issued by such an entity.

13 “(F) Any security issued by a real estate
14 investment trust.

15 “(G) Any other arrangement as deter-
16 mined by the Secretary.

17 “(2) SPECIAL RULES RELATING TO STRAIGHT
18 DEBT SECURITIES.—

19 “(A) IN GENERAL.—For purposes of para-
20 graph (1)(A), securities meet the requirements
21 of this paragraph if such securities are straight
22 debt, as defined in section 1361(c)(5) (without
23 regard to subparagraph (B)(iii) thereof).

24 “(B) SPECIAL RULES RELATING TO CER-
25 TAIN CONTINGENCIES.—For purposes of sub-

1 paragraph (A), any interest or principal shall
2 not be treated as failing to satisfy section
3 1361(c)(5)(B)(i) solely by reason of the fact
4 that the time of payment of such interest or
5 principal is subject to a contingency, but only
6 if—

7 “(i) any such contingency does not
8 have the effect of changing the effective
9 yield to maturity, as determined under sec-
10 tion 1272, other than a change in the an-
11 nual yield to maturity which either—

12 “(I) does not exceed the greater
13 of $\frac{1}{4}$ of 1 percent or 5 percent of the
14 annual yield to maturity, or

15 “(II) results solely from a default
16 or the exercise of a prepayment right
17 by the issuer of the debt, or

18 “(ii) neither the aggregate issue price
19 nor the aggregate face amount of the
20 issuer’s debt instruments held by the trust
21 exceeds \$1,000,000 and not more than 12
22 months of unaccrued interest can be re-
23 quired to be prepaid thereunder.

24 “(C) SPECIAL RULES RELATING TO COR-
25 PORATE OR PARTNERSHIP ISSUERS.—In the

1 case of an issuer which is a corporation or a
2 partnership, securities that otherwise would be
3 described in paragraph (1)(A) shall be consid-
4 ered not to be so described if the trust holding
5 such securities and any of its controlled taxable
6 REIT subsidiaries (as defined in subsection
7 (d)(8)(A)(iv)) hold any securities of the issuer
8 which—

9 “(i) are not described in paragraph
10 (1) (prior to the application of paragraph
11 (1)(C)), and

12 “(ii) have an aggregate value greater
13 than 1 percent of the issuer’s outstanding
14 securities.

15 “(3) LOOK-THROUGH RULE FOR PARTNERSHIP
16 SECURITIES.—

17 “(A) IN GENERAL.—For purposes of ap-
18 plying subclause (III) of subsection
19 (c)(4)(B)(iii)—

20 “(i) a trust’s interest as a partner in
21 a partnership (as defined in section
22 7701(a)(2)) shall not be considered a secu-
23 rity, and

1 “(ii) the trust shall be deemed to own
2 its proportionate share of each of the as-
3 sets of the partnership.

4 “(B) DETERMINATION OF TRUST’S INTER-
5 EST IN PARTNERSHIP ASSETS.—For purposes
6 of subparagraph (A), with respect to any tax-
7 able year beginning after the date of the enact-
8 ment of this subparagraph—

9 “(i) the trust’s interest in the partner-
10 ship assets shall be the trust’s propor-
11 tionate interest in any securities issued by
12 the partnership (determined without re-
13 gard to subparagraph (A)(i) and para-
14 graph (4), but not including securities de-
15 scribed in paragraph (1)), and

16 “(ii) the value of any debt instrument
17 shall be the adjusted issue price thereof, as
18 defined in section 1272(a)(4).

19 “(4) CERTAIN PARTNERSHIP DEBT INSTRU-
20 MENTS NOT TREATED AS A SECURITY.—For pur-
21 poses of applying subclause (III) of subsection
22 (c)(4)(B)(iii)—

23 “(A) any debt instrument issued by a part-
24 nership and not described in paragraph (1)
25 shall not be considered a security to the extent

1 of the trust's interest as a partner in the part-
2 nership, and

3 “(B) any debt instrument issued by a part-
4 nership and not described in paragraph (1)
5 shall not be considered a security if at least 75
6 percent of the partnership's gross income (ex-
7 cluding gross income from prohibited trans-
8 actions) is derived from sources referred to in
9 subsection (c)(3).

10 “(5) SECRETARIAL GUIDANCE.—The Secretary
11 is authorized to provide guidance (including through
12 the issuance of a written determination, as defined
13 in section 6110(b)) that an arrangement shall not be
14 considered a security held by the trust for purposes
15 of applying subclause (III) of subsection
16 (c)(4)(B)(iii) notwithstanding that such arrangement
17 otherwise could be considered a security under sub-
18 paragraph (F) of subsection (c)(5).”.

19 **SEC. 102. CLARIFICATION OF APPLICATION OF LIMITED**
20 **RENTAL EXCEPTION.**

21 Subparagraph (A) of section 856(d)(8) (relating to
22 special rules for taxable REIT subsidiaries) is amended
23 to read as follows:

24 “(A) LIMITED RENTAL EXCEPTION.—

1 “(i) IN GENERAL.—The requirements
2 of this subparagraph are met with respect
3 to any property if at least 90 percent of
4 the leased space of the property is rented
5 to persons other than taxable REIT sub-
6 sidiaries of such trust and other than per-
7 sons described in paragraph (2)(B).

8 “(ii) RENTS MUST BE SUBSTANTIALLY
9 COMPARABLE.—Clause (i) shall apply only
10 to the extent that the amounts paid to the
11 trust as rents from real property (as de-
12 fined in paragraph (1) without regard to
13 paragraph (2)(B)) from such property are
14 substantially comparable to such rents paid
15 by the other tenants of the trust’s property
16 for comparable space.

17 “(iii) TIMES FOR TESTING RENT COM-
18 PARABILITY.—The substantial com-
19 parability requirement of clause (ii) shall
20 be treated as met with respect to a lease
21 to a taxable REIT subsidiary of the trust
22 if such requirement is met under the terms
23 of the lease—

24 “(I) at the time such lease is en-
25 tered into,

1 “(II) at the time of each exten-
2 sion of the lease, including a failure to
3 exercise a right to terminate, and

4 “(III) at the time of any modi-
5 fication of the lease between the trust
6 and the taxable REIT subsidiary if
7 the rent under such lease is effectively
8 increased pursuant to such modifica-
9 tion.

10 With respect to subclause (III), if the tax-
11 able REIT subsidiary of the trust is a con-
12 trolled taxable REIT subsidiary of the
13 trust, the term ‘rents from real property’
14 shall not in any event include rent under
15 such lease to the extent of the increase in
16 such rent on account of such modification.

17 “(iv) CONTROLLED TAXABLE REIT
18 SUBSIDIARY.—For purposes of clause (iii),
19 the term ‘controlled taxable REIT sub-
20 sidiary’ means, with respect to any real es-
21 tate investment trust, any taxable REIT
22 subsidiary of such trust if such trust owns
23 directly or indirectly—

24 “(I) stock possessing more than
25 50 percent of the total voting power

1 of the outstanding stock of such sub-
2 sidiary, or

3 “(II) stock having a value of
4 more than 50 percent of the total
5 value of the outstanding stock of such
6 subsidiary.

7 “(v) CONTINUING QUALIFICATION
8 BASED ON THIRD PARTY ACTIONS.—If the
9 requirements of clause (i) are met at a
10 time referred to in clause (iii), such re-
11 quirements shall continue to be treated as
12 met so long as there is no increase in the
13 space leased to any taxable REIT sub-
14 sidiary of such trust or to any person de-
15 scribed in paragraph (2)(B).

16 “(vi) CORRECTION PERIOD.—If there
17 is an increase referred to in clause (v) dur-
18 ing any calendar quarter with respect to
19 any property, the requirements of clause
20 (iii) shall be treated as met during the
21 quarter and the succeeding quarter if such
22 requirements are met at the close of such
23 succeeding quarter.”

1 **SEC. 103. DELETION OF CUSTOMARY SERVICES EXCEPTION.**

2 Subparagraph (B) of section 857(b)(7) (relating to
3 redetermined rents) is amended by striking clause (ii) and
4 by redesignating clauses (iii), (iv), (v), (vi), and (vii) as
5 clauses (ii), (iii), (iv), (v), and (vi), respectively.

6 **SEC. 104. CONFORMITY WITH GENERAL HEDGING DEFINI-**
7 **TION.**

8 (a) DEFINITION.—Subparagraph (G) of section
9 856(c)(5) (relating to treatment of certain hedging instru-
10 ments) is amended to read as follows:

11 “(G) TREATMENT OF CERTAIN HEDGING
12 INSTRUMENTS.—Except to the extent provided
13 by regulations, any income of a real estate in-
14 vestment trust from a hedging transaction (as
15 defined in clause (ii) or (iii) of section
16 1221(b)(2)(A)) which is clearly identified pur-
17 suant to section 1221(a)(7), including gain
18 from the sale or disposition of such a trans-
19 action, shall not constitute gross income under
20 paragraph (2) to the extent that the transaction
21 hedges any indebtedness incurred or to be in-
22 curred by the trust to acquire or carry real es-
23 tate assets.”.

1 **SEC. 105. CONFORMITY WITH REGULATED INVESTMENT**
2 **COMPANY RULES.**

3 Clause (i) of section 857(b)(5)(A) (relating to imposi-
4 tion of tax in case of failure to meet certain requirements)
5 is amended by striking “90 percent” and inserting “95
6 percent”.

7 **SEC. 106. PROHIBITED TRANSACTIONS PROVISIONS.**

8 (a) **EXPANSION OF PROHIBITED TRANSACTION SAFE**
9 **HARBOR.**—Section 857(b)(6) (relating to income from
10 prohibited transactions) is amended by redesignating sub-
11 paragraphs (D) and (E) as subparagraphs (E) and (F),
12 respectively, and by inserting after subparagraph (C) the
13 following new subparagraph:

14 “(D) **CERTAIN SALES NOT TO CONSTITUTE**
15 **PROHIBITED TRANSACTIONS.**—For purposes of
16 this part, the term ‘prohibited transaction’ does
17 not include a sale of property which is a real es-
18 tate asset (as defined in section 856(c)(5)(B))
19 if—

20 “(i) the trust held the property for
21 not less than 4 years in connection with
22 the trade or business of producing timber,

23 “(ii) the aggregate expenditures made
24 by the trust, or a partner of the trust, dur-
25 ing the 4-year period preceding the date of
26 sale which—

1 “(I) are includible in the basis of
2 the property (other than timberland
3 acquisition expenditures), and

4 “(II) are directly related to oper-
5 ation of the property for the produc-
6 tion of timber or for the preservation
7 of the property for use as timberland,
8 do not exceed 30 percent of the net selling
9 price of the property,

10 “(iii) the aggregate expenditures made
11 by the trust, or a partner of the trust, dur-
12 ing the 4-year period preceding the date of
13 sale which—

14 “(I) are includible in the basis of
15 the property (other than timberland
16 acquisition expenditures), and

17 “(II) are not directly related to
18 operation of the property for the pro-
19 duction of timber, or for the preserva-
20 tion of the property for use as
21 timberland, do not exceed 5 percent of
22 the net selling price of the property,

23 “(iv)(I) during the taxable year the
24 trust does not make more than 7 sales of
25 property (other than sales of foreclosure

1 property or sales to which section 1033 ap-
2 plies), or

3 “(II) the aggregate adjusted bases (as
4 determined for purposes of computing
5 earnings and profits) of property (other
6 than sales of foreclosure property or sales
7 to which section 1033 applies) sold during
8 the taxable year does not exceed 10 per-
9 cent of the aggregate bases (as so deter-
10 mined) of all of the assets of the trust as
11 of the beginning of the taxable year,

12 “(v) in the case that the requirement
13 of clause (iv)(I) is not satisfied, substan-
14 tially all of the marketing expenditures
15 with respect to the property were made
16 through an independent contractor (as de-
17 fined in section 856(d)(3)) from whom the
18 trust itself does not derive or receive any
19 income, and

20 “(vi) the sales price of the property
21 sold by the trust to its taxable REIT sub-
22 sidiary is not based in whole or in part on
23 the income or profits of the subsidiary or
24 the income or profits that the subsidiary

1 derives from the sale or operation of such
2 property.”.

3 **SEC. 107. EFFECTIVE DATES.**

4 (a) IN GENERAL.—Except as provided in subsection
5 (b), the amendments made by this title shall apply to tax-
6 able years beginning after December 31, 2000.

7 (b) SECTIONS 103 THROUGH 106.—The amend-
8 ments made by sections 103, 104, 105 and 106 shall apply
9 to taxable years beginning after the date of the enactment
10 of this Act.

11 **TITLE II—FIRPTA CORRECTION**

12 **SEC. 201. MODIFICATION OF THE TREATMENT OF CERTAIN**
13 **REIT DISTRIBUTIONS ATTRIBUTABLE TO**
14 **GAIN FROM SALES OR EXCHANGES OF**
15 **UNITED STATES REAL PROPERTY INTERESTS.**

16 (a) IN GENERAL.—Paragraph (1) of section 897(h)
17 (relating to look-through of distributions) is amended by
18 inserting before the period at the end the following: “, ex-
19 cept that any distribution by a REIT with respect to any
20 class of stock which is regularly traded on an established
21 securities market located in the Unites States shall not
22 be treated as gain recognized from the sale or exchange
23 of a United States real property interest if the shareholder
24 did not own more than 5 percent of such class of stock
25 during the taxable year.”.

1 (b) EFFECTIVE DATE.—The amendment made by
 2 this section shall apply to taxable years beginning after
 3 the date of the enactment of this Act.

4 **TITLE III—REIT SAVINGS**
 5 **PROVISIONS**

6 **SEC. 301. REVISIONS TO REIT PROVISIONS.**

7 (a) RULES OF APPLICATION FOR FAILURE TO SAT-
 8 ISFY SECTION 856(c)(4).—Section 856(c) (relating to def-
 9 inition of real estate investment trust), as amended by sec-
 10 tion 101, is amended by inserting after paragraph (6) the
 11 following new paragraph:

12 “(7) RULES OF APPLICATION FOR FAILURE TO
 13 SATISFY PARAGRAPH (4).—

14 “(A) DE MINIMIS FAILURE.—A corpora-
 15 tion, trust, or association that fails to meet the
 16 requirements of paragraph (4)(B)(iii) for a par-
 17 ticular quarter shall nevertheless be considered
 18 to have satisfied the requirements of such para-
 19 graph for such quarter if—

20 “(i) such failure is due to the owner-
 21 ship of assets the total value of which does
 22 not exceed the lesser of—

23 “(I) 1 percent of the total value
 24 of the trust’s assets at the end of the

1 quarter for which such measurement
2 is done, and

3 “(II) \$10,000,000, and

4 “(ii)(I) the corporation, trust, or asso-
5 ciation, following the identification of such
6 failure, disposes of assets in order to meet
7 the requirements of such paragraph within
8 6 months after the last day of the quarter
9 in which the corporation, trust or associa-
10 tion’s identification of the failure to satisfy
11 the requirements of such paragraph oc-
12 curred or such other time period prescribed
13 by the Secretary and in the manner pre-
14 scribed by the Secretary, or

15 “(II) the requirements of such para-
16 graph are otherwise met within the time
17 period specified in subclause (I).

18 “(B) FAILURES EXCEEDING DE MINIMIS
19 AMOUNT.—A corporation, trust, or association
20 that fails to meet the requirements of para-
21 graph (4) for a particular quarter shall never-
22 theless be considered to have satisfied the re-
23 quirements of such paragraph for such quarter
24 if—

1 “(i) such failure involves the owner-
2 ship of assets the total value of which ex-
3 ceeds the de minimis standard described in
4 subparagraph (A)(i) at the end of the
5 quarter for which such measurement is
6 done,

7 “(ii) following the corporation, trust,
8 or association’s identification of the failure
9 to satisfy the requirements of such para-
10 graph for a particular quarter, a descrip-
11 tion of each asset that causes the corpora-
12 tion, trust, or association to fail to satisfy
13 the requirements of such paragraph at the
14 close of such quarter of any taxable year is
15 set forth in a schedule for such quarter
16 filed in accordance with regulations pre-
17 scribed by the Secretary,

18 “(iii) the failure to meet the require-
19 ments of such paragraph for a particular
20 quarter is due to reasonable cause and not
21 due to willful neglect,

22 “(iv) the corporation, trust, or asso-
23 ciation pays a tax computed under sub-
24 paragraph (C), and

1 “(v)(I) the corporation, trust, or asso-
2 ciation disposes of the assets set forth on
3 the schedule specified in clause (ii) within
4 6 months after the last day of the quarter
5 in which the corporation, trust or associa-
6 tion’s identification of the failure to satisfy
7 the requirements of such paragraph oc-
8 curred or such other time period prescribed
9 by the Secretary and in the manner pre-
10 scribed by the Secretary, or

11 “(II) the requirements of such para-
12 graph are otherwise met within the time
13 period specified in subclause (I).

14 “(C) TAX.—For purposes of subparagraph
15 (B)(iv)—

16 “(i) TAX IMPOSED.—If a corporation,
17 trust, or association elects the application
18 of this subparagraph, there is hereby im-
19 posed a tax on the failure described in sub-
20 paragraph (B) of such corporation, trust,
21 or association. Such tax shall be paid by
22 the corporation, trust, or association.

23 “(ii) TAX COMPUTED.—The amount
24 of the tax imposed by clause (i) shall be
25 the greater of—

1 “(I) \$50,000, or

2 “(II) the amount determined
3 (pursuant to regulations promulgated
4 by the Secretary) by multiplying the
5 net income generated by the assets
6 described in the schedule specified in
7 subparagraph (B)(ii) for the period
8 specified in clause (iii) by the highest
9 rate of tax specified in section 11.

10 “(iii) PERIOD.—For purposes of
11 clause (ii)(II), the period described in this
12 clause is the period beginning on the first
13 date that the failure to satisfy the require-
14 ments of such paragraph (4) occurs as a
15 result of the ownership of such assets and
16 ending on the earlier of the date on which
17 the trust disposes of such assets or the end
18 of the first quarter when there is no longer
19 a failure to satisfy such paragraph (4).

20 “(iv) ADMINISTRATIVE PROVISIONS.—
21 For purposes of subtitle F, the taxes im-
22 posed by this subparagraph shall be treat-
23 ed as excise taxes with respect to which the
24 deficiency procedures of such subtitle
25 apply.”.

1 (b) MODIFICATION OF RULES OF APPLICATION FOR
2 FAILURE TO SATISFY SECTIONS 856(c)(2) OR
3 856(c)(3).—Paragraph (6) of section 856(c) (relating to
4 definition of real estate investment trust) is amended by
5 striking subparagraphs (A) and (B), by redesignating sub-
6 paragraph (C) as subparagraph (B), and by inserting be-
7 fore subparagraph (B) (as so redesignated) the following
8 new subparagraph:

9 “(A) following the corporation, trust, or
10 association’s identification of the failure to meet
11 the requirements of paragraph (2) or (3), or of
12 both such paragraphs, for any taxable year, a
13 description of each item of its gross income de-
14 scribed in such paragraphs is set forth in a
15 schedule for such taxable year filed in accord-
16 ance with regulations prescribed by the Sec-
17 retary, and”.

18 (c) REASONABLE CAUSE EXCEPTION TO LOSS OF
19 REIT STATUS IF FAILURE TO SATISFY REQUIRE-
20 MENTS.—Subsection (g) of section 856 (relating to termi-
21 nation of election) is amended—

22 (1) in paragraph (1) by inserting before the pe-
23 riod at the end of the first sentence the following:
24 “unless paragraph (5) applies”, and

1 (2) by adding at the end the following new
2 paragraph:

3 “(5) ENTITIES TO WHICH PARAGRAPH AP-
4 PLIES.—This paragraph applies to a corporation,
5 trust, or association—

6 “(A) which is not a real estate investment
7 trust to which the provisions of this part apply
8 for the taxable year due to one or more failures
9 to comply with one or more of the provisions of
10 this part (other than subsection (c)(6) or (c)(7)
11 of section 856),

12 “(B) such failures are due to reasonable
13 cause and not due to willful neglect, and

14 “(C) if such corporation, trust, or associa-
15 tion pays (as prescribed by the Secretary in
16 regulations and in the same manner as tax) a
17 penalty of \$50,000 for each failure to satisfy a
18 provision of this part due to reasonable cause
19 and not willful neglect.”.

20 (d) DEDUCTION OF TAX PAID FROM AMOUNT RE-
21 QUIRED TO BE DISTRIBUTED.—Subparagraph (E) of sec-
22 tion 857(b)(2) is amended by striking “(7)” and inserting
23 “(7) of this subsection, section 856(c)(7)(B)(iii), and sec-
24 tion 856(g)(1).”.

1 (e) EXPANSION OF DEFICIENCY DIVIDEND PROCE-
2 DURE.—Subsection (e) of section 860 is amended by strik-
3 ing “or” at the end of paragraph (2), by striking the pe-
4 riod at the end of paragraph (3) and inserting “; or”, and
5 by adding at the end the following new paragraph:

6 “(4) a statement by the taxpayer attached to its
7 amendment or supplement to a return of tax for the
8 relevant tax year.”.

9 (f) EFFECTIVE DATE.—The amendments made by
10 this section shall apply to taxable years beginning after
11 date of the enactment of this Act.

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