be treated as having held such property for at least 4 years if—

(i) the secured property is sold or otherwise disposed of pursuant to a case under title 11 of the United States Code,

(ii) the seller is under the jurisdiction of the court in such case, and

(iii) the disposition is required by the court or is pursuant to a plan approved by the court.

(B) Exception. Subparagraph (A) shall not apply if—

(i) the secured property was acquired by the seller with the intent to evict or foreclose, or

(ii) the trust knew or had reason to know that default on the obligation described in paragraph (5)(A) would occur.

(5) Definitions. For purposes of this subsection—

(A) Shared appreciation provision. The term "shared appreciation provision" means any provision—

(i) which is in connection with an obligation which is held by the real estate investment trust and is secured by an interest in real property, and

(ii) which entitles the real estate investment trust to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain which would be realized if the property were sold on a specified date) or appreciation in value as of any specified date.

(B) Secured property. The term "secured property" means the real property referred to in subparagraph (A).

(k) Requirement that entity not be closely held treated as met in certain cases.

A corporation, trust, or association—

(1) which for a taxable year meets the requirements of section 857(f)(1), and

(2) which does not know, or exercising reasonable diligence would not have known, whether the entity failed to meet the requirement of subsection (a)(6),

shall be treated as having met the requirement of subsection (a)(6) for the taxable year.

• *Caution:* Subsec. (l), following, is effective for tax. yrs. begin. after 12/31/2000.

(l) Taxable REIT subsidiary.

For purposes of this part—

(1) In general. The term "taxable REIT subsidiary" means, with respect to a real estate investment trust, a corporation (other than a real estate investment trust) if—

(A) such trust directly or indirectly owns stock in such corporation, and

(B) such trust and such corporation jointly elect that such corporation shall be treated as a taxable REIT subsidiary of such trust for purposes of this part.

Such an election, once made, shall be irrevocable unless both such trust and corporation consent to its revocation. Such election, and any revocation thereof, may be made without the consent of the Secretary.

(2) 35 percent ownership in another taxable REIT subsidiary. The term "taxable REIT subsidiary" includes, with respect to any real estate investment trust, any corporation (other than a real estate investment trust) with respect to which a taxable REIT subsidiary of such trust owns directly or indirectly—

(A) securities possessing more than 35 percent of the total voting power of the outstanding securities of such corporation, or

(B) securities having a value of more than 35 percent of the total value of the outstanding securities of such corporation.

The preceding sentence shall not apply to a qualified REIT subsidiary (as defined in subsection (i)(2)). The rule of section 856(c)(7) shall apply for purposes of subparagraph (B).

(3) Exceptions. The term "taxable REIT subsidiary" shall not include—

(A) any corporation which directly or indirectly operates or manages a lodging facility or a health care facility, and

(B) any corporation which directly or indirectly provides to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or health care facility is operated.

Subparagraph (B) shall not apply to rights provided to an eligible independent contractor to operate or manage a lodging facility if such rights are held by such corporation as a franchisor, licensee, or in a similar capacity and such lodging facility is either owned by such corporation or is leased to such corporation from the real estate investment trust.

(4) Definitions. For purposes of paragraph (3)—

(A) Lodging facility. The term "lodging facility" has the meaning given to such term by paragraph (9)(D)(ii).

(B) Health care facility. The term "health care facility" has the meaning given to such term by subsection (e)(6)(D)(ii).

In 1999, P.L. 106-170, Sec. 532(c)(2)(B), substituted "section 1221(a)(1)" for "section 1221(1)" in subpara. (c)(2)(D). Sec. 532(c)(2)(D), substituted "section 1221(a)(1)" for section 1221(1)" in subpara. (c)(9)(C). Sec. 532(c)(2)(J), substituted "section 1221(a)(1)" for "section 1221(1)" in para. (e)(1). Sec. 532(c)(2)(K), substituted "section 1221(a)(1)" for "section 1221(1)" in subpara. (g)(2)(B) effective for any instrument held, acquired or entered into, any transaction entered into, and supplies held or acquired on or after 12/17/99.

--P.L. 106-170, Sec. 541(a), amended subpara. (c)(4)(B). Sec. 541(b), added para. (c)(7) effective for tax. yrs. begin. after 12/31/2000. For transitional rules see Sec. 541(b) of this Act, which reads as follows:

"(b) Transitional rules related to section 541.

"(1) Existing arrangements.

"(A) In general. Except as otherwise provided in this paragraph, the amendment made by section 541 shall not apply to a real estate investment trust with respect to—

"(i) securities of a corporation held directly or indirectly by such trust on July 12, 1999,

"(ii) securities of a corporation held by an entity on July 12, 1999, if such trust acquires control of such entity pursuant to a written binding contract in effect on such date and at all times thereafter before such acquisition,

"(iii) securities received by such trust (or a successor) in exchange for or with respect to securities described in clause (i) or (ii) in a transaction in which gain or loss is not recognized, and

"(iv) securities acquired directly or indirectly by such trust as part of a reorganization (as defined in section 368(a)(1)) of the Internal Revenue Code of 1986) with respect to such trust if such securities are described in clause (i), (ii), or (iii) with respect to any other real estate investment trust.

"(B) New trade or business or substantial new assets. Subparagraph (A) shall cease to apply to securities of a corporation as of the first day after July 12, 1999, on which such corporation engages in a substantial new line of business or acquires any substantial asset, other than—

"(i) pursuant to a binding contract in effect on such date and at all times thereafter before the acquisition of such asset,

"(ii) in a transaction in which gain or loss is not recognized by reason of section 1031 or 1033 of the Internal Revenue Code of 1986, or

separate treatment of distributions made after the end of the taxable year for purposes of the earnings and profits rule. Treasury regulations under the REIT provisions state that "distribution procedures similar to those ... for regulated investment companies apply to non-REIT earnings and profits of a real estate investment trust."

Description of Proposal

Taxable REIT subsidiaries

[587] Under the proposal, a REIT generally could not own more than 10 percent of the total value of securities of a single issuer, in addition to the present law limit of the REIT's ownership to no more than 10 percent of the outstanding voting securities of a single issuer.

[588] For purposes of the new 10 percent value test, securities would generally be defined to exclude safe harbor debt owned by a REIT (as defined for purposes of section 1361(c)(5)(B)(i) and (ii)) if the REIT (and any taxable REIT subsidiary of such REIT) owns no other securities of the issuer. In the case of a REIT that owns securities of a partnership, safe harbor debt would be excluded from the definition of securities only if the REIT owns at least 20 percent or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20 percent profits interest is to assure that if the partnership produces income that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly, even though it may also derive qualified interest income through its safe harbor debt interest.

[589] An exception to the limitations on ownership of securities of a single issuer would apply in the case of a "taxable REIT subsidiary" that meets certain requirements. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT) of which a taxable REIT subsidiary owns, directly or indirectly, more than 35 percent of the vote or value is automatically treated as a taxable REIT subsidiary. Securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries could not exceed 25 percent of the total value of a REIT's assets.

[590] A taxable REIT subsidiary would be able to engage in certain business activities that under present law could disqualify the REIT because, but for the proposal, the taxable REIT subsidiary's activities and relationship with the REIT could prevent certain income from qualifying as rents from real property. Specifically, the subsidiary could provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and could manage or operate properties generally, without causing amounts received or accrued directly or indirectly by REIT for such activities to fail to be treated as rents from real property.

[591] However, the subsidiary could not directly or indirectly operate or manage a lodging or healthcare facility. Nevertheless, it could lease a qualified lodging facility (e.g, a hotel) from the REIT (provided no gambling revenues were derived by the hotel or on its premises); and the rents paid would be treated as rents from real property so long as the lodging facility was operated by an independent contractor for a fee. The subsidiary could bear all expenses of operating the facility and receive all the net revenues, minus the independent contractor's fee.

[592] For purposes of the rule that an independent contractor may operate a qualified lodging facility, an independent contractor will qualify so long as, at the time it enters into the management agreement

th the taxable REIT subsidiary, it is actively engaged in the trade or business of operating qualified lodging facilities for any person who is not related to the REIT or the taxable REIT subsidiary. The REIT may receive income from such an independent contractor with respect to certain pre-existing leases.

[593] Also, the subsidiary generally could not provide to any person rights to any brand name under which hotels or healthcare facilities are operated. An exception applies to rights provided to an independent contractor to operate or manage a lodging facility, if the rights are held by the subsidiary as licensee or franchisee, and the lodging facility is owned by the subsidiary or leased to it by the REIT.

[594] Interest paid by a taxable REIT subsidiary to the related REIT would be subject to the earnings stripping rules of section 163(j). Thus the taxable REIT subsidiary could not deduct interest in any year that would exceed 50 percent of the subsidiary's adjusted gross income.

[595] If any amount of interest, rent, or other deductions of the taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arm's length ("redetermined" items), an excise tax of 100% would be imposed on the portion that was excessive. "Safe harbors" would be provided for certain rental payments where the amounts are de minimis, there is specified evidence that charges to unrelated parties are substantially comparable, certain charges for services from the taxable REIT subsidiary are separately stated, or the subsidiary's gross income from the service is not less than 150 percent of the subsidiary's direct cost in furnishing the service.

[596] In determining whether rents are arm's length rents, the fact that such rents do not meet the requirements of the specified safe harbors shall not be taken into account. In addition, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

[597] The Commissioner of Internal Revenue is to conduct a study to determine how many taxable REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries. The Commissioner shall submit a report to the Congress describing the results of such study.

Health Care REITS

[598] The proposal would permit a REIT to own and operate a health care facility for at least two years, and treat it as permitted "foreclosure" property, if the facility is acquired by the termination or expiration of a lease of the property. Extensions of the 2 year period could be granted.

Conformity with regulated investment company rules

[599] The REIT distribution requirements would be modified to conform to the rules for regulated investment companies. Specifically, a REIT would be required to distribute only 90 percent, rather than 95 percent, of its income.

Definition of independent contractor

[600] If any class of stock of the REIT or the person being tested as an independent contractor is regularly traded on an established securities market, only persons who directly or indirectly own 5 percent or more of such class of stock shall be counted in determining whether the 35 percent