IV. OTHER CHANGES

Other AJCA changes directly affecting REITs include provisions: i) expanding the applicable definition of a "hedging transaction" and providing that certain such hedging transactions entered into to reduce interest rate risk on real estate debt will be disregarded for purposes of the REIT income tests (effective for tax years beginning after October 22, 2004); ii) eliminating a safe harbor from the 100% excise tax on deductions improperly shifted between a REIT and its taxable REIT subsidiary (effective for tax years beginning after October 22, 2004); iii) providing practical clarification of how to test whether rents a REIT receives from its taxable REIT subsidiary will qualify as "good" real estate income under the applicable REIT income tests (effective for tax years beginning after 2000); iv) adding an opportunity for a REIT to pay deficiency dividends for past year failures identified by the REIT (effective for tax years beginning after October 22, 2004); and v) providing a safe harbor for qualifying REIT sales of timber allowing such sales to avoid the prohibited transactions tax on dealer sales (effective for tax years beginning after October 22, 2004). I.R.C. §§ 856(c)(5)(G), 857(b)(7)(B), 856(d)(8)(A), 860(e)(4), and 857(b)(6)(D).

V. CONCLUSION

Notwithstanding these generally favorable changes, REIT tax compliance remains a technical and complex balancing act that must inform virtually everything a REIT does. The failure or violation of one of the myriad applicable tax rules can still lead to significant taxes and penalties. Nonetheless, these changes, to the extent some are retroactive, provide certainty to REITs for past tax years and, prospectively, generally improve the tax landscape for REIT operations and transactions. As a result of the AJCA, REITs now enjoy greater flexibility in how and what they invest in, increased prospects for foreign investment in the REIT, more certainty as to whether REIT operations will comply with tax rules, and less risk for inadvertent violations of those rules. These changes together should, on balance, enhance REITs' comparative attractiveness as real estate investment vehicles.

COBRA'S BITE: RETIREE MEDICAL BENEFITS IN A CHAPTER 11 BANKRUPTCY AND AFTER ACQUISITIONS

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Unlike qualified pension benefits, welfare benefits do not vest automatically. Employee Retirement Income Security Act of 1974 ("ERISA") §201(1); *see also* Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73, 78 (1995). Accordingly, an employer must typically perform some affirmative act, such as making an irrevocable promise to employees that such benefits are permanent in order for future benefits to become guaranteed. *See e.g.* In re Unisys Corp. Retiree Med. Benefit ERISA Litigation, 58 F.3d 896, 901 (3d Cir. 1995). Absent such action, an employer may reduce and/or eliminate prospective welfare benefits at virtually any time. Retiree medical benefits typically follow this general rule. However, employers who attempt to eliminate retiree medical benefits within one year before or after the filing of a Chapter 11 bankruptcy petition may find that section 4980B of the Code ("COBRA"), operates to vest this particular welfare benefit without any other affirmative act by the employer. Arguably then, the law permits employers to eliminate retiree medical benefits at anytime, unless the employer's business can no longer afford to provide such benefits. In addition, COBRA could make a purchaser liable for continuing coverage of former employees of a target even if the purchaser never employed those individuals itself.

COBRA

Generally, COBRA requires all employers who employed at least 20 employees in the preceding calendar year to offer continuing health coverage to an employee, the employee's spouse and/or dependent children (a "qualifying beneficiary"), who participate in the employer's group health plan if the employee or qualifying beneficiary loses coverage under the plan after a "qualifying event." I.R.C. § 4980B. A qualifying event occurs if the employee or a qualifying beneficiary loses health coverage as a result of: (a) the employee's death; (b) the employee's termination or reduction of hours; (c) the divorce of the employee from the employee's spouse; (d) the employee becoming eligible to receive Medicare benefits; (e) an employee's dependent child no longer qualifying under the terms of the plan; or (f) a substantial elimination of retiree health coverage occurring within one year before or after the commencement of a bankruptcy proceeding. I.R.C. § 4980B(f)(3)(A)-(F). The continuation coverage offered must be identical to the health coverage offered to similarly situated individuals that remain actively covered under the employer's health plan. I.R.C. § 4980B(f)(2)(A). If the employer alters or eliminates the health coverage provided to its remaining active employees, then the employer can amend the continuation coverage offered under COBRA. *Id.*

COBRA also mandates the period during which the health coverage must be offered to employees after a qualifying event. Regardless of the circumstance of the loss of coverage, an employer will no longer be obligated to offer continuation coverage if the employer does not maintain a health plan for its employees who have not undergone a qualifying event. I.R.C. § 4980B(e)(2)(B)(2). Additionally, COBRA does not require the employer to continue to offer continuation coverage to a participant who obtains coverage under another group health plan after a qualifying event. Treas. Reg. § 54.4980B-7, Q&A #2. If neither of these events occur in the interim, the maximum period of required continuation coverage under COBRA for non-bankruptcy related qualifying events is 18 to 36 months after such qualifying event,

with the most typical period of continuation coverage being 18 months. 4980B(f)(2)(B). However, if a participant loses coverage under a retiree medical plan within one year of the date a Chapter 11 bankruptcy petition is filed, then COBRA requires that the continuation coverage extend until the death of the participant, or for qualified beneficiaries, the date that is 36 months after the date of the death of the employee. I.R.C. § 4980B(f)(2)(B)(III). This lifetime provision of health care coverage under COBRA approximates the retiree coverage under the employer's health plan and cannot be terminated while the employer maintains a health plan for its active employees. COBRA effectively vests benefits that were intended to be discretionary.

Although the employer is not required to pay the full cost of such coverage, as COBRA permits employers to charge the employees for the coverage, there may still be high costs associated with the mandates of COBRA. The employer may charge as much as 102% of the cost of coverage for a participant who has not undergone a qualifying event (section 4980B(f) (2)(C)(i)), but this is typically not sufficient to cover the true cost of the coverage due to adverse selection. The cost of COBRA coverage is expensive for most individuals; accordingly, only the more unhealthy retirees or the higher consumers of health care will elect to purchase COBRA coverage. Healthier retirees might not elect continuation coverage. This limits the coverage pool and generally only the bad risks stay enrolled in the continuation coverage.

The retirees' choice in electing continuation coverage has a negative effect on the employer, regardless of whether the employer self-funds its welfare obligation or the employer purchases insurance to provide such benefits. If the employer self-funds its insurance obligations, each claim made by this group will be paid out of the general assets of the employer. Thus, each claim has a real cost for each dollar in claims paid that exceed the COBRA premium. Moreover, if the employer purchases insurance to meet these expenses, the employer will most likely have a bad experience rating, which will eventually raise the costs of insurance to the employer. Under COBRA, these increased costs cannot simply be passed on to those enrolled in continuation coverage and any such costs become vested expenses of the employer, even if the employer could have terminated the underlying welfare benefit at any time prior to bankruptcy.

COBRA AND CORPORATE TRANSACTIONS

The impact of COBRA is not limited to employers in bankruptcy. The COBRA rules could cause a subsequent employer to have to pay lifetime retiree medical benefits to workers that the subsequent employer never actually employed. An acquiror of a business that has terminated its retiree medical program in the context of a Chapter 11 bankruptcy will find that even structuring the transaction as an asset sale, which typically reduces the acquiror's potential liability for the debts of the target, may not be effective to avoid the target's liability under COBRA.

In 2001, Treasury finalized regulations (the "M&A Regulations") that addressed the responsibility for COBRA continuation coverage in the context of business transactions. Treas. Reg. § 54.4980B-9. Both in a stock sale and in an asset sale, the seller's controlled group is primarily liable to provide any required COBRA continuation coverage to participants whose qualifying event occurred prior to or in connection with the sale. Treas. Reg. § 54.4980B-9, Q&A 8(a). However, if the seller's controlled group eliminates its group health plan at any time after the sale or if the buyer purchases the entire controlled group of the seller, the buyer must provide the required COBRA continuation coverage to such participants, if the buyer is a "successor employer" under the M&A Regulations. *Id.* A buyer in a stock sale is virtually guaranteed to be a "successor employer." Treas. Reg. § 54.4980B-9, Q&A 8(b). A buyer in an asset sale will be a "successor employer," if the acquiror "continues the business operations associated with the assets purchased from the selling group without interruption or substantial change." Treas. Reg. § 54.4980B-9, Q&A 8(c). In fact, the M&A Regulations specifically provide that the buyer in an asset sale occurring in the context of a Chapter 11 bankruptcy will specifically be liable for the COBRA obligation of the bankrupt target if the buyer continues the business of the target. *Id.* This does not conform with typical common law notions of when a purchaser in an asset sale is a successor to the target. Although the seller and buyer may allocate liability for COBRA continuation coverage between the parties, if either party fails to perform as negotiated, the remaining party must perform as would have been required under the M&A Regulations in the absence of any such negotiation. Treas. Reg. § 54.4980B-9, Q&A 7. Thus, the lifetime COBRA obligation may transfer and become a liability of the acquiror, regardless of what form the transaction takes or of the parties' intent.

COBRA AND CORPORATE TRANSACTIONS SUMMARY

Due to the M&A Regulations, the buyer of a bankrupt entity may become responsible for providing lifetime COBRA coverage for the former employees of the target. Therefore, if any target in a potential transaction has been, or is currently, involved in a bankruptcy proceeding, focus should turn to the existence of a retiree medical plan. If such a plan is still in place, the parties could covenant that the target will not eliminate or "substantially reduce" such coverage within one year of the bankruptcy petition. If the target has already terminated its retiree medical plan, the acquiror must determine the cost of providing lifetime continuation coverage under COBRA to those who lost coverage within one year of the bankruptcy petition and account for such cost in any determination of the target's worth. Without taking these steps, the acquiror could be purchasing an unexpected lifelong liability. ■