Sunstone Hotel Investors, Inc.
Form 424B5
July 20, 2006
**Table of Contents**

Filed pursuant to Rule 424(b)(5).
A filing fee of $12,091, calculated in accordance with Rule 457(r),
has been transmitted to the SEC in connection with the
Common Stock offered from the registration statement
(File No. 333-130480) by means of this prospectus supplement.

PROSPECTUS SUPPLEMENT

(To Prospectus dated December 19, 2005)

# 4,000,000 Shares

# Sunstone Hotel Investors, Inc.

## Common Stock

## $28.25 per share

We have entered into a forward sale agreement under which we will sell 4,000,000 shares of our common stock to an affiliate of Citigroup Global Markets Inc., which affiliate we refer to as the forward counterparty. The forward counterparty is initially selling 4,000,000 shares of our common stock under this prospectus supplement through Citigroup Global Markets Inc. to hedge its position under the forward sale agreement. The forward counterparty has advised us that it intends to borrow the shares of our common stock to be sold under this prospectus supplement from third party stock lenders. We will not receive any proceeds from the sale of the shares of our common stock by the forward counterparty.

We would receive proceeds, subject to certain adjustments as described in this prospectus supplement, from the sale of the shares subject to the forward sale agreement upon physical settlement of the forward sale agreement on a date or dates specified by us within one year from the date of the closing of this offering. If we instead elect to settle the forward sale agreement in cash or on a net share basis, we may not receive any proceeds, and we may owe cash or shares to the forward counterparty on settlement. See Forward Sale Agreement.

Our common stock currently trades on the New York Stock Exchange, or NYSE, under the symbol SHO. On July 18, 2006, the last reported sale price of our common stock was $29.00 per share. Shares of our common stock are subject to ownership and transfer limitations that must be applied to maintain our status as a real estate investment trust, or REIT.

**See Risk Factors beginning on page S-4 of this prospectus to review certain risk factors, and to obtain information about where to read certain additional factors, you should consider before buying shares of our common stock in this offering.**

**Neither the Securities and Exchange Commission nor any other state or federal regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.**

| | Per Share | Total |
|---|---|---|
| Public offering price | $ 28.25 | $ 113,000,000 |
| Underwriting commission | $ 0.50 | $ 2,000,000 |
| Proceeds to forward counterparty (before expenses)(1) | $ 27.75 | $ 111,000,000 |

(1) We will not receive any proceeds from the sale of shares by the forward counterparty. If we physically settle the forward sale agreement in common stock, we expect to receive proceeds in the amount of approximately $111.0 million upon physical settlement in common stock of the forward sale agreement as described in this prospectus supplement, subject to certain adjustments pursuant to the forward sale agreement as described in this prospectus supplement, which settlement will be within approximately one year from the date of the closing of this offering. For purposes of calculating the aggregate net proceeds we expect to receive upon physical settlement of the forward sale agreement, we have assumed that the forward sale agreement will be physically settled in common stock based upon the initial forward sale price of $27.75 per share. See Forward Sale Agreement.

In addition to the underwriting discount, the underwriter will receive a commission equivalent from the investors in the amount of $0.05 for each share of common stock sold to the investors in the offering.

The underwriter expects to deliver the shares in New York, New York on or about July 24, 2006.

# Citigroup

The date of this Prospectus Supplement is July 18, 2006.

**Table of Contents**

## TABLE OF CONTENTS

### Prospectus Supplement



### Prospectus



**You should rely only on the information contained in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference. We have not authorized anyone to provide you with different information. These securities are not being offered in any jurisdiction where the offer is not permitted. You should not assume that the information contained in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference is accurate as of any date other than the date on the front of the respective document.**

**Table of Contents**

## INCORPORATION OF CERTAIN INFORMATION BY REFERENCE

The SEC s rules allow us to incorporate by reference information into this prospectus supplement and the attached prospectus. This means that we can disclose important information to you by referring you to another document. Any information referred to in this way is considered part of this prospectus supplement and the attached prospectus from the date we file that document. Any reports filed by us with the SEC after the date of this prospectus supplement and before the date that the offering of the securities by means of this prospectus supplement is terminated will automatically update and, where applicable, supersede any information contained, or incorporated by reference, in this prospectus supplement or in the attached prospectus.

We incorporate by reference into this prospectus supplement and the attached prospectus the documents or information referred to under the heading Incorporation of Certain Information by Reference in the attached prospectus. We also incorporate by reference filings we made with the SEC after the filings referred to under the heading Incorporation of Certain Information by Reference in the attached prospectus but before the date of this prospectus supplement.

The documents incorporated by reference in this prospectus supplement and the attached prospectus and, in particular, our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, and the information under the heading Risk Factors in the aforementioned Annual Report on Form 10-K, contain important information about us.

You should read Incorporation of Certain Information by Reference in the attached prospectus for information about how to obtain the documents incorporated by reference.

**Table of Contents**

## THE OFFERING

| | |
|---|---|
| Common stock offered by the forward counterparty | 4,000,000 Shares. |
| Total shares of common stock outstanding after this offering, assuming physical settlement of the forward sale agreement | 62,016,015 Shares. This number is based on 58,016,015 shares of our common stock outstanding at July 18, 2006 and: |
| | does not include 1,681,665 additional shares of our common stock available for future issuance under our 2004 long-term incentive plan, of which 439,046 shares have been reserved for issuance to our employees pursuant to restricted stock units which are unvested at the closing of this offering; |
| | does not include shares of common stock issuable upon conversion of our outstanding series C cumulative convertible redeemable preferred stock; and |
| | assumes that the forward sale agreement is physically settled and that we issue 4,000,000 shares of common stock in connection with such settlement, which settlement will be within one year from the date of this prospectus supplement. |
| Use of proceeds | We will not receive any proceeds from the sale of our common stock by the forward counterparty. If we physically settle the forward sale agreement in common stock, we expect to receive net proceeds of approximately $111.0 million upon such physical settlement, subject to certain adjustments pursuant to the forward sale agreement. We intend to contribute any net proceeds that we receive upon physical settlement of the forward sale agreement to our operating partnership in exchange for additional membership units of our operating partnership. Our operating partnership will subsequently use those net proceeds for general corporate purposes, potentially including, but not limited to, the repayment of outstanding amounts under our revolving credit facility and acquisitions by us or any of our subsidiaries, including the financing of a portion of the purchase price for the possible acquisition described under Recent Developments. There can be no assurance that we will enter into a purchase agreement related to or consummate the possible acquisition described under Recent Developments. See Use of Proceeds. |
| Distribution policy | To maintain our qualification as a REIT, we intend to make quarterly distributions to our stockholders of at least 90% of our REIT taxable income (which excludes net capital gains and does not necessarily equal net income as calculated in accordance with generally accepted accounting principles, or GAAP). We paid a quarterly dividend of $0.30 per share of common stock, a quarterly dividend of $0.50 per share of Series A cumulative redeemable preferred stock and a quarterly dividend of $0.393 per share of Series C convertible redeemable preferred stock on July 17, 2006 to stockholders of record on June 30, 2006. |

**Table of Contents**

| | |
|---|---|
| New York Stock Exchange symbol | SHO |
| Principal executive offices | Our principal executive offices are located at 903 Calle Amanecer, Suite 100, San Clemente, California 92673. Our telephone number is (949) 369-4000. Our website is located at www.sunstonehotels.com. Information on our website is not deemed to be a part of this prospectus supplement or the attached prospectus. |

**Table of Contents**

## RISK FACTORS

See the information under the heading Risk Factors beginning on p. 8 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, which information has been incorporated by reference into this prospectus supplement, and other information included in this prospectus supplement and the attached prospectus for a discussion of factors you should carefully consider before deciding to invest in shares of our common stock.

### Risks related to the Forward Sale Agreement

*Settlement provisions contained in the forward sale agreement could result in substantial dilution to our earnings per share, return on equity and dividends per share or result in substantial cash payment obligations.*

The forward counterparty has the right to accelerate the forward sale agreement and require us to settle on a date specified by the forward counterparty if (1) it is unable, after using commercially reasonable efforts, to borrow, or maintain its borrowing of, shares of our common stock at all or at a cost less than a specified amount, (2) we declare any dividend or distribution on shares of our common stock payable in cash in excess of a specified amount, (3) we are the subject of a merger or takeover or other similar events, or (4) certain other events of default or termination events occur, including, among other things, our filing for bankruptcy or the delisting of our common stock from the New York Stock Exchange. The forward counterparty s decision to exercise its right to require us to settle the forward sale agreement will be made irrespective of our need for capital. In such cases, we could be required to issue and deliver common stock under the terms of the physical settlement provisions of the forward sale agreement irrespective of our capital needs, which would result in dilution to our earnings per share, return on equity and dividends per share until we identify and acquire revenue generating assets that will produce earnings and cash flow to ameliorate the effects of such dilution.

Under the forward sale agreement we have agreed to deliver to the forward counterparty 4,000,000 shares of our common stock within one year from the date of the closing of this offering, but we may settle the forward sale agreement earlier at our option. At our election, we may pay (or receive) the difference between the cash value of any shares to be delivered at maturity and the physical settlement purchase price or we may deliver (or receive) a number of shares of our common stock with a value equal to that difference. If we decide to physically settle the forward sale agreement, delivery of our shares on the physical settlement of the forward sale agreement may result in more shares of our common stock being issued than is desirable, which may result in the dilution of our earnings per share, return on equity and dividends per share. If we elect cash settlement or net share settlement for all or a portion of the shares of common stock included in the forward sale agreement, we would expect the forward counterparty to repurchase a number of shares equal to the portion for which we elect cash settlement or net share settlement, adjusted by the amount of any net share delivery, in order to cover its obligation to return the shares of our common stock it has borrowed from third parties in connection with sales of our common stock under this prospectus supplement and satisfy any remaining cash or net share delivery obligation to us under the forward sale agreement. In addition, the purchase of our common stock by the forward counterparty to unwind its hedge positions could cause the price of our common stock to increase over the time during which the cash settlement amount or net share settlement is being established, thereby increasing the amount of cash or shares we would owe to the forward counterparty upon a cash settlement or net share settlement of the forward sale agreement. If the market value of our common stock at the time of the repurchase is above the forward price, we would pay the forward counterparty under the forward sale agreement an amount in cash or shares equal to the difference. Thus, we could be responsible for a potentially substantial cash payment or share delivery. See Forward Sale Agreement for information on the forward sale agreement.

In certain circumstances relating to, among other things, the price of our common stock, we may not be permitted to cash settle or net share settle the forward sale agreement. In such an event, we may be required to physically settle the forward sale agreement which may result in more shares of our common stock being issued than is desirable, which may result in the dilution of our earnings per share, return on equity and dividends per share.

**Table of Contents**

*In case of our bankruptcy or insolvency, the forward sale agreement will automatically terminate, and we would not receive the expected proceeds from the sale of our shares.*

If we file for or consent to a proceeding seeking a judgment in bankruptcy or insolvency or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors rights, or we or a regulatory authority with jurisdiction over us present a petition for our winding-up or liquidation and we consent to such a petition, or any other event of default under the forward sale agreement occurs as a result of a proceeding related to us under applicable bankruptcy laws, the forward sale agreement will terminate. If the forward sale agreement so terminates, we would not be obligated to deliver to the forward counterparty any shares not previously delivered, and the forward counterparty would be discharged from its obligation to pay the settlement price in respect of any shares not previously settled. Therefore, to the extent that there are any shares with respect to which the forward sale agreement have not been settled at the time of the commencement of any bankruptcy or insolvency proceedings, we would not receive the settlement price in respect of those shares.

*The treatment of the cash that we might receive from cash settlement of the forward sale agreement would have uncertain U.S. Federal income tax consequences.*

In the event that we elect to settle the forward sale agreement for cash and the settlement price is below the forward price, we would be entitled to receive a cash payment from the forward counterparty. Under Section 1032 of the Internal Revenue Code of 1986, as amended (the Code ), generally, no gains and losses are recognized by a corporation in dealing in its own shares; however, the tax law is unclear as to the tax treatment of cash received by a corporation from the cash settlement of a forward agreement to sell the corporation s own shares. In the event that we recognize a significant gain from the cash settlement of the forward sale agreement, we might not be able to satisfy the gross income requirements applicable to REITs under the Code (as described under U.S. Federal Income Tax Considerations below). In that case, we may be able to rely upon the relief provisions under the Code in order to avoid the loss of our REIT status. Even if the relief provisions apply, we will be subject to a 100% tax on the greater of (i) the excess of 75% of our gross income (excluding gross income from prohibited transactions) over the amount of such income attributable to sources that qualify under the 75% test, as discussed below under U.S. Federal Income Tax Considerations Requirements for Qualification as a REIT and Income Tests, or (ii) the excess of 95% of our gross income (excluding gross income from prohibited transactions) over the amount of such gross income attributable to sources that qualify under the 95% test, as discussed below under U.S. Federal Income Tax Considerations Requirements for Qualification as a REIT and Income Tests, multiplied in either case by a fraction intended to reflect our profitability. In the event that these relief provisions were not available, we could lose our REIT status under the Code.

*In case we make cash payments to settle the forward sale agreement, we might not have enough cash to satisfy the REIT distribution requirements.*

In the event that we elect to settle the forward sale agreement for cash and the settlement price is greater than the forward price, we would be required to make a payment in cash to the forward counterparty. In the event that we are required to make a significant payment in cash to settle the forward sale agreement, we might not be able to satisfy the distribution requirements applicable to REITs under the Code, absent additional debt or equity financing. There can be no assurance that we will be able to obtain any such financing on terms favorable to us, or at all. In the event that we are unable to comply with the distribution requirements, we could lose our REIT status under the Code. See also U.S. Federal Income Tax Considerations below.

Table of Contents

## USE OF PROCEEDS

We will not receive any proceeds from the sale of our common stock by the forward counterparty. If we physically settle the forward sale agreement in common stock, we expect to receive net proceeds of approximately $111.0 million upon such physical settlement, subject to certain adjustments contemplated by the forward sale agreement. We intend to contribute any net proceeds that we receive upon physical settlement of the forward sale agreement to our operating partnership in exchange for additional membership units of our operating partnership. Our operating partnership will subsequently use those net proceeds for general corporate purposes, including, but not limited to, the repayment of outstanding amounts under our revolving credit facility and acquisitions by us or any or our subsidiaries, including the potential financing of a portion of the purchase price for the possible acquisition described under Recent Developments. See Recent Developments.

## SPECIAL NOTE ABOUT FORWARD LOOKING STATEMENTS

*This prospectus supplement contains forward-looking statements within the meaning of federal securities laws and regulations, including references to forecasts of future results. Forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors which may cause the actual results to differ materially from those anticipated at the time the forward-looking statements are made. Forward-looking statements in this prospectus supplement are subject to various risks and uncertainties concerning specific factors described in Sunstone Hotel Investors, Inc. s Form 10-K for the fiscal year ended December 31, 2005, Sunstone s Form 10-Q for the quarter ended March 31, 2006 and other SEC filings. Such information contained herein represents management s best judgment as of the date hereof based on information currently available. Sunstone Hotel Investors, Inc. does not intend to update this information and disclaims any legal obligation to the contrary. Historical information is not necessarily indicative of future performance.*

Table of Contents

## RECENT DEVELOPMENTS

Consistent with our strategy of adding to our portfolio of hotels through the acquisition of luxury and upper-upscale hotels in major U.S. markets, we are in discussions with respect to the possible acquisition of an upper-upscale hotel in a major metropolitan area. If we enter into an agreement with respect to this possible acquisition and the closing conditions contained in such agreement are satisfied, we expect to finance a portion of the purchase price by electing to settle the forward sale agreement and finance the remainder through debt and other cash sources. At this time, we have not entered into any agreements with respect to this possible acquisition.

In addition, and consistent with our business strategy to create a core portfolio of hotels in the luxury and upper-upscale segments of the hotel industry, we have entered into an agreement with a third party to sell up to 13 of our non-core hotels, which represented in the aggregate approximately 6.5% of our total revenues for the quarter ending March 31, 2006 and approximately 5.6% of our total assets as of March 31, 2006. This third party is currently conducting its due diligence review of these thirteen hotels and its obligations are subject, among other things, to its satisfaction with the results of its due diligence review. We can provide no assurance that this potential sale will occur as contemplated in the applicable agreement.

Table of Contents

## U.S. FEDERAL INCOME TAX CONSIDERATIONS

The following discussion describes the material Federal income tax consequences to stockholders of their ownership of shares of our common stock and preferred stock and supersedes in its entirety the discussion of Federal income tax consequences under the heading U.S. Federal Income Tax Considerations in the attached prospectus. The tax treatment of holders of depository shares is not described herein and will be described in the applicable prospectus supplement. The tax treatment of stockholders will vary depending upon the stockholder s particular situation, and this discussion addresses only stockholders that hold shares of our common stock, or preferred stock, as a capital asset and does not address all aspects of taxation that may be relevant to particular stockholders in light of their personal investment or tax circumstances. This section also does not address all aspects of taxation that may be relevant to certain types of stockholders to which special provisions of the Federal income tax laws apply, including:

- dealers in securities or currencies;
- traders in securities that elect to use a mark-to-market method of accounting for their securities holdings;
- banks;
- tax-exempt organizations;
- certain insurance companies;
- persons liable for the alternative minimum tax;
- persons that hold common stock as a hedge against interest rate or currency risks or as part of a straddle or conversion transaction; and
- stockholders whose functional currency is not the U.S. dollar.

Sullivan & Cromwell LLP has reviewed this summary and is of the opinion that the material Federal income tax consequences to stockholders of their ownership of shares of our common stock and preferred stock are as summarized in this discussion. In providing its opinion, Sullivan & Cromwell LLP is relying as to certain factual matters upon the statements and representations contained in certificates provided to Sullivan & Cromwell LLP by us.

This summary is based on the Code, its legislative history, existing and proposed regulations under the Code, published rulings and court decisions. This summary describes the provisions of these sources of law only as they are currently in effect. All of these sources of law may change at any time, and any change in the law may apply retroactively.

We urge you to consult with your own tax advisors regarding the tax consequences to you of acquiring, owning and selling shares of our common stock and preferred stock including the Federal, state, local and foreign tax consequences of acquiring, owning and selling shares of our common stock and preferred stock in your particular circumstances and potential changes in applicable laws.

### Taxation as a REIT

In the opinion of Sullivan & Cromwell LLP, commencing with our taxable year ending December 31, 2004, we have been organized in conformity with the requirements for qualification and taxation as a REIT under the Code, and our proposed method of operation will enable us to continue to meet the requirements for qualification and taxation as a REIT under the Code. You should be aware, however, that opinions of counsel are not binding upon the IRS or any court.

Table of Contents

The qualification of Sunstone Hotel Investors as a REIT will depend upon its continuing satisfaction of the requirements of the Code relating to qualification for REIT status. Some of these requirements depend upon actual operating results, distribution levels, diversity of stock ownership, asset composition, source of income and record keeping. Accordingly, while we intend to continue to qualify to be taxed as a REIT, the actual results of our operations for any particular year might not satisfy these requirements. Sullivan & Cromwell LLP will not monitor our compliance with the requirements for REIT qualification on an ongoing basis.

The sections of the Code applicable to REITs are highly technical and complex. The following discussion summarizes some material aspects of the relevant sections of the Code.

As a REIT, we generally will not have to pay Federal corporate income taxes on net income that we currently distribute to our stockholders. This treatment substantially eliminates the double taxation at the corporate and stockholder levels that generally results from investment in a regular corporation. Our dividends, however, generally will not be eligible for (i) the reduced tax rates applicable to dividends received by noncorporate stockholders or (ii) the corporate dividends received deduction.

Moreover, we will have to pay Federal income or excise tax as follows:

First, we will have to pay tax at regular corporate rates on any undistributed REIT taxable income, including undistributed net capital gains.

Second, under certain circumstances, we may have to pay the alternative minimum tax on items of tax preference.

Third, if we have (a) net income from the sale or other disposition of foreclosure property, as defined in the Code, which is held primarily for sale to customers in the ordinary course of business or (b) other non-qualifying income from foreclosure property, we will have to pay tax at the highest corporate rate on that income.

Fourth, if we have net income from prohibited transactions, as defined in the Code, we will have to pay a 100% tax on that income. Prohibited transactions are, in general, certain sales or other dispositions of property, other than foreclosure property, held primarily for sale to customers in the ordinary course of business. Unless a sale of real property qualifies for a safe harbor, the question of whether the sale of a hotel (or other property) constitutes the sale of property held primarily for sale to customers is generally a question of the facts and circumstances regarding a particular transaction. We and our subsidiaries intend to hold the interests in our hotels for investment with a view to long-term appreciation, to engage in the business of acquiring and owning hotels and to make occasional sales as are consistent with our investment objectives. We do not intend to engage in prohibited transactions. We cannot assure you, however, that we will only make sales that satisfy the requirements of the safe harbors or that the IRS will not successfully assert that one or more of such sales are prohibited transactions.

Fifth, if we should fail to satisfy the 75% gross income test or the 95% gross income test, as discussed below under Requirements for Qualification as a REIT and Income Tests, but we have nonetheless maintained our qualification as a REIT because we have satisfied other requirements necessary to maintain REIT qualification, we will have to pay a 100% tax on an amount equal to (a) the gross income attributable to the greater of (i) 75% of our gross income over the amount of gross income that is qualifying income for purposes of the 75% test, and (ii) 95% (90% for our taxable year ending December 31, 2004) of our gross income over the amount of gross income that is qualifying income for purposes of the 95% test, multiplied by (b) a fraction intended to reflect our profitability.

Sixth, if we should fail to distribute during each calendar year at least the sum of (1) 85% of our real estate investment trust ordinary income for that year, (2) 95% of our real estate investment trust capital gain net income for that year and (3) any undistributed taxable income from prior periods, we would have to pay a 4% excise tax on the excess of that required distribution over the amounts actually distributed.

Seventh, if we acquire any asset from a C corporation in certain transactions in which we adopt the basis of the asset or any other property in the hands of the C corporation as our basis of the asset in our hands, and we recognize gain on the disposition of that asset during the 10-year period beginning on the date on which we acquired that asset, then we will have to pay tax on the built-in gain at the highest regular corporate rate. A C corporation means generally a corporation that has to pay full corporate-level tax. Because we acquired the assets held by certain C corporations in connection with our initial public offering, we will be subject to corporate income tax with respect to the current built-in gain in the assets previously held by such corporation if we sell any of the assets currently held by such corporation prior to October 2014.

Eighth, if we receive non-arm s length income from, or non-arm s length deductions are incurred by, Sunstone Hotel TRS Lessee Inc., we will be subject to a 100% tax on the amount of our non-arm s length income.

Ninth, if we fail to satisfy a REIT asset test, as described below, due to reasonable cause and we nonetheless maintain our REIT qualification because of specified cure provisions, we will generally be required to pay a tax equal to the greater of $50,000 or the highest corporate tax rate multiplied by the net income generated by the nonqualifying assets that caused us to fail such test.

Tenth, if we fail to satisfy any provision of the Code that would result in our failure to qualify as a REIT (other than a violation of the REIT gross income tests or a violation of the asset tests described below) and the violation is due to reasonable cause, we may retain our REIT qualification but will be required to pay a penalty of $50,000 for each such failure.

**Requirements for Qualification as a REIT**

The Code defines a REIT as a corporation, trust or association

- that is managed by one or more trustees or directors;
- the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest;
- that would otherwise be taxable as a domestic corporation, but for Sections 856 through 859 of the Code;
- that is neither a financial institution nor an insurance company to which certain provisions of the Code apply;
- the beneficial ownership of which is held by 100 or more persons;
- that, during the last half of each taxable year, has no more than 50% in value of its outstanding stock owned, directly or constructively, by five or fewer individuals, as defined in the Code to include certain entities; and
- that meets certain other tests, described below, regarding the nature of its income and assets.

The Code provides that the conditions described in the first through fourth bullet points above must be met during the entire taxable year, and that the condition described in the fifth bullet point above must be met during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months.

We expect that we will satisfy the conditions described in the first through fifth bullet points of the preceding paragraph and believe that we will also satisfy the condition described in the sixth bullet point of the preceding paragraph. In addition, our charter provides for restrictions regarding the ownership and transfer of our common stock. These restrictions are intended to assist us in continuing to satisfy the share ownership requirements described in the fifth and sixth bullet points of the second preceding paragraph. The ownership and

**Table of Contents**

transfer restrictions pertaining to the common stock are described in the attached prospectus under the heading Description of Our Capital Stock Restrictions on Ownership and Transfer.

If, as in our case, a REIT is a partner in a partnership, Treasury regulations provide that the REIT will be deemed to own its proportionate capital share of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to that share. In addition, the character of the assets and gross income of the partnership will retain the same character in the hands of the REIT for purposes of Section 856 of the Code, including satisfying the gross income tests and the asset tests. Thus, our proportionate share of the assets, liabilities and items of income of Sunstone Hotel Partnership, LLC, or Sunstone Hotel Partnership, in or through which we conduct substantially all of our business, which partnership interests are our principal and only assets, will be treated as assets, liabilities and items of income of ours for purposes of applying the requirements described in this section. In addition, actions taken by Sunstone Hotel Partnership can affect our ability to satisfy the REIT income and assets tests and the determination of whether we have net income from prohibited transactions. (See the fourth bullet point under Taxation as a REIT for a discussion of prohibited transactions.) Accordingly, for purposes of this discussion, when we discuss our actions, income or assets we intend that to include the actions, income or assets of Sunstone Hotel Partnership.

**Taxable REIT Subsidiaries**

A taxable REIT subsidiary, or TRS, is any corporation in which a REIT directly or indirectly owns stock, provided that the REIT and that corporation make a joint election to treat that corporation as a TRS. The election can be revoked at any time as long as the REIT and the TRS revoke such election jointly. In addition, if a TRS holds, directly or indirectly, more than 35% of the securities of any other corporation other than a REIT (by vote or by value), then that other corporation is also treated as a TRS. A corporation can be a TRS with respect to more than one REIT.

A TRS is subject to Federal income tax at regular corporate rates (currently a maximum rate of 35%), and may also be subject to state and local taxation. Any dividends paid or deemed paid by any one of our TRSs will also be subject to tax, either (1) to us if we do not pay the dividends received to our stockholders as dividends, or (2) to our stockholders if we do pay out the dividends received to our stockholders. We may hold more than 10% of the stock of a TRS without jeopardizing our qualification as a REIT notwithstanding the rule described below under Asset Tests that generally precludes ownership of more than 10% of any issuer s securities. However, as noted below, in order for us to qualify as a REIT, the securities of all of the TRSs in which we have invested either directly or indirectly may not represent more than 20% of the total value of our assets. We expect that the aggregate value of all of our interests in TRSs will represent less than 20% of the total value of our assets; however, we cannot assure that this will always be true. Other than certain activities related to operating or managing a lodging or health care facility as more fully described below under Income Tests, a TRS may generally engage in any business including the provision of customary or non-customary services to tenants of the parent REIT.

As described below, income we receive from operating or managing hotels is not qualified income for either the 75% or 95% income tests described more fully below under Income Tests. Accordingly, the entity through which we hold an interest in the hotels will lease the hotels to the TRS Lessee, and the TRS Lessee will engage independent third parties to operate the hotels.

A TRS is not permitted to directly or indirectly operate or manage a hotel but a TRS can lease a hotel provided that the TRS meets the following conditions:

First, the hotel must be a qualified lodging facility. A qualified lodging facility is a hotel, motel or other establishment more than one-half of the dwelling units in which are used on a transient basis, unless wagering activities are conducted at or in connection with such facility by any person who is engaged in the business of accepting wagers and who is legally authorized to engage in such business at or in connection with such facility. Accordingly, we will not be permitted to have gambling or wagering activity on the premises of any of our hotels or to earn income from gambling or wagering activities.

Second, the manager must be an eligible independent contractor. An eligible independent contractor is an independent contractor that, at the time the management contract is entered into, is actively engaged in the trade or business of operating qualified lodging facilities for any person not related to the REIT or the TRS. For this purpose, an independent contractor means any person (i) that does not own (taking into account relevant attribution rules) more than 35% of the stock of the REIT, and (ii) with respect to which no person or group owning directly or indirectly (taking into account relevant attribution rules) 35% or more of the REIT owns 35% or more directly or indirectly (taking into account relevant attribution rules) of the ownership interest in the contractor. Accordingly, our TRS Lessee will not directly operate or manage the hotels. Rather, our TRS Lessee will enter into management contracts with hotel management companies which will operate and manage the hotels. To the best of our knowledge and belief, such hotel management companies are eligible independent contractors. The TRS Lessee is permitted to bear the expenses of the eligible independent contractor of operating the hotel pursuant to the management contract.

**Income Tests**

In order to maintain our qualification as a REIT, we annually must satisfy two gross income requirements:

First, we must generally derive at least 75% of our gross income, excluding gross income from prohibited transactions, for each taxable year directly or indirectly from investments relating to real property or mortgages on real property, including rents from real property, as defined in the Code, or from certain types of temporary investments. Rents from real property generally include our expenses that are paid or reimbursed by tenants.

Second, at least 95% of our gross income, excluding gross income from prohibited transactions, for each taxable year must generally be derived from real property investments as described in the preceding bullet point, dividends (including dividends from a TRS), interest, gain from the sale or disposition of stock or securities or from any combination of these types of sources.

Rents that we receive will qualify as rents from real property in satisfying the gross income requirements for a REIT described above only if the rents satisfy several conditions:

First, the amount of rent must not be based in whole or in part on the income or profits of any person. However, an amount received or accrued generally will not be excluded from rents from real property solely because it is based on a fixed percentage or percentages of receipts or sales. Accordingly, the leases of our hotels to the TRS Lessee are based on the gross receipts of the TRS Lessee from the hotels.

Second, the Code provides that rents received from a tenant will not qualify as rents from real property in satisfying the gross income tests if the REIT, directly or under the applicable attribution rules, owns a 10% or greater interest in that tenant; except that rents received from a TRS under certain circumstances qualify as rents from real property even if we own a 10% or greater interest in the subsidiary. We refer to a tenant in which we own a 10% or greater interest as a related party tenant. As described above, it is our business plan that most or all of our rental income will be from the leases to our TRS Lessee.

Third, if rent attributable to personal property leased in connection with a lease of real property is greater than 15% of the total rent received under the lease, then the portion of rent attributable to the personal property will not qualify as rents from real property.

Finally, for rents received to qualify as rents from real property, the REIT generally must not operate or manage the property or furnish or render services to the tenants of the property, other than through an independent contractor from whom the REIT derives or receives no income or through a TRS. However, we may directly perform certain services that landlords usually or customarily render when renting

S-12

**Table of Contents**

space for occupancy only or that are not considered rendered to the occupant of the property. In addition, as described more fully below, rent paid by a TRS to a REIT pursuant to a lease of a qualified lodging facility that is managed and operated by an eligible independent contractor can qualify as rents from real property.

The leases to the TRS Lessee provide for a base rent plus a fixed percentage of the gross revenue from operation of the hotel. Each such lease must be a true lease. If the leases to our TRS Lessee are not respected as true leases we could be disqualified as a REIT. While we intend that each lease will be respected as a true lease, the determination of whether a lease is a true lease is inherently a question of fact and circumstances and we cannot assure you that the IRS will not successfully assert that the leases to the TRS Lessee should not be respected as true leases.

Except as described above with respect to the TRS Lessee, we do not expect to derive significant rents from related party tenants. We also do not intend to derive rental income attributable to personal property.

We believe that the leases of the hotels to the TRS Lessee will conform with normal business practice, contain arm s length terms and that the rent payable under those leases will be treated as rents from real property for purposes of the 75% and 95% gross income tests. However, we cannot assure you that the IRS will not successfully assert a contrary position or that a change in circumstances will not cause a portion of the rent payable under the leases to fail to qualify as rents from real property. If such failures were in sufficient amounts, we may not be able to satisfy either or both of the 75% or 95% gross income tests and could lose our REIT status. In addition, if the IRS successfully reapportions or reallocates items of income, deduction and credit among and between us and our TRS Lessee under the leases or any intercompany transaction because it determines that doing so is necessary to prevent the evasion of taxes or to clearly reflect income, we could be subject to a 100% excise tax on those amounts.

While we will monitor the activities of the eligible independent contractor to maximize the value of our hotel investments, neither we nor our TRS Lessee will directly or indirectly manage our hotels. Similarly, while our tenants may benefit from the services we will provide related to monitoring and, when appropriate, advising the eligible independent contractor regarding the management of the hotel for the purpose of maximizing the value of our investments, we do not believe that these activities will cause gross income attributable to the leases with our TRS Lessee to fail to be treated as rents from real property.

Other than as described in the preceding paragraph, we do not expect to perform any services for our tenants. If we were to provide services to a tenant that are other than those landlords usually or customarily provide when renting space for occupancy only, amounts received or accrued by us for any of these services will not be treated as rents from real property for purposes of the REIT gross income tests. However, the amounts received or accrued for these services will not cause other amounts received with respect to the property to fail to be treated as rents from real property unless the amounts treated as received in respect of the services, together with amounts received for certain management services, exceed 1% of all amounts received or accrued by us during the taxable year with respect to the property. If the sum of the amounts received in respect of the services to tenants and management services described in the preceding sentence exceeds the 1% threshold, then all amounts received or accrued by us with respect to the property will not qualify as rents from real property, even if we provide the impermissible services to some, but not all, of the tenants of the property.

The term interest generally does not include any amount received or accrued, directly or indirectly, if the determination of that amount depends in whole or in part on the income or profits of any person. However, an amount received or accrued generally will not be excluded from the term interest solely because it is based on a fixed percentage or percentages of receipts or sales.

From time to time, we may enter into hedging transactions with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps, and floors, options to

Table of Contents

purchase these items, and futures and forward contracts. Except to the extent provided by Treasury Regulations, any income we derive from a hedging transaction that is clearly identified as such as specified in the Code, including gain from the sale or disposition of such a transaction, will not constitute gross income for purposes of the 95% gross income test, and therefore will be exempt from this test, but only to the extent that the transaction hedges indebtedness incurred or to be incurred by us to acquire or carry real estate. Income from any hedging transaction will, however, be nonqualifying for purposes of the 75% gross income test. The term hedging transaction, as used above, generally means any transaction we enter into in the normal course of our business primarily to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by us. We intend to structure any hedging transactions in a manner that does not jeopardize our status as a REIT.

If we fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, we may nevertheless qualify as a REIT for that year if we satisfy the requirements of other provisions of the Code that allow relief from disqualification as a REIT. We believe that the aggregate amount of our nonqualifying income, from all sources, in any taxable year will not exceed the limit on nonqualifying income under the gross income tests. If we fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, we may nevertheless qualify as a REIT for the year if we are entitled to relief under certain provisions of the Code. Commencing with our taxable year beginning January 1, 2005, we generally may make use of the relief provisions if:

- following our identification of the failure to meet the 75% or 95% gross income tests for any taxable year, we file a schedule with the IRS setting forth each item of our gross income for purposes of the 75% or 95% gross income tests for such taxable year in accordance with Treasury Regulations to be issued; and

- our failure to meet these tests was due to reasonable cause and not due to willful neglect.

We might not be entitled to the benefit of these relief provisions, however. As discussed in the fifth bullet point under Taxation as a REIT, even if these relief provisions apply, we would have to pay a tax on the excess income.

**Asset Tests**

At the close of each quarter of our taxable year, we also must satisfy three tests relating to the nature of our assets:

- First, at least 75% of the value of our total assets must be represented by real estate assets, including (a) real estate assets held by our qualified REIT subsidiaries, our allocable share of real estate assets held by partnerships in which we own an interest and stock issued by another REIT, (b) for a period of one year from the date of our receipt of proceeds of an offering of its shares of beneficial interest or publicly offered debt with a term of at least five years, stock or debt instruments purchased with these proceeds and (c) cash, cash items and government securities.

- Second, not more than 25% of our total assets may be represented by securities other than those in the 75% asset class.

- Third, not more than 20% of our total assets may constitute securities issued by one or more TRSs and of the investments included in the 25% asset class, the value of any one issuer s securities, other than securities issued by another REIT or by us may not exceed 5% of the value of our total assets, and we may not own more than 10% of the total vote or total value of any one issuer s outstanding securities, except in the case of a TRS as described above or certain straight debt instruments. For our taxable year beginning January 1, 2005, certain types of securities are disregarded as securities solely for purposes of determining whether we meet the 10% value test described above, including but not limited to any loan to an individual or estate, any obligation to pay rents from real property, and any security

Table of Contents

issued by a REIT. Also, solely for the purposes of the 10% value test described above, the determination of our interest in the assets of any partnership or limited liability company in which we own an interest will be based on our proportionate interest in any securities issued by the partnership or limited liability company, excluding for this purpose certain securities described in the Code. As a consequence, if the IRS successfully challenges the partnership status of any of the partnerships in which we maintain an interest, and the partnership is reclassified as a corporation or a publicly traded partnership taxable as a corporation we could lose our REIT status.

Certain relief provisions may be available to us if we fail to satisfy the asset tests described above after the 30 day cure period. Under these provisions, we will be deemed to have met the 5% and 10% REIT asset tests if the value of our nonqualifying assets (i) does not exceed the lesser of (a) 1% of the total value of our assets at the end of the applicable quarter and (b) $10,000,000, and (ii) we dispose of the nonqualifying assets within (a) six months after the last day of the quarter in which the failure to satisfy the asset tests is discovered or (b) the period of time prescribed by Treasury Regulations to be issued. For violations due to reasonable cause and not willful neglect that are not described in the preceding sentence, we may avoid disqualification as a REIT under any of the asset tests, after the 30 day cure period, by taking steps including (i) the disposition of the nonqualifying assets to meet the asset test within (a) six months after the last day of the quarter in which the failure to satisfy the asset tests is discovered or (b) the period of time prescribed by Treasury Regulations to be issued, (ii) paying a tax equal to the greater of (a) $50,000 or (b) the highest corporate tax rate multiplied by the net income generated by the nonqualifying assets, and (iii) disclosing certain information to the IRS.

**Annual Distribution Requirement**

We are required to distribute dividends, other than capital gain dividends, to our stockholders in an amount at least equal to (1) the sum of (a) 90% of our real estate investment trust taxable income, computed without regard to the dividends paid deduction and our net capital gain, and (b) 90% of the net after-tax income, if any, from foreclosure property minus (2) the sum of certain items of non-cash income.

These distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for the year to which they relate and if paid on or before the first regular dividend payment after the declaration.

To the extent that we do not distribute all of our net capital gain or distribute at least 90%, but less than 100%, of our real estate investment trust taxable income, as adjusted, we will have to pay tax on those amounts at regular ordinary and capital gain corporate tax rates. Furthermore, if we fail to distribute during each calendar year at least the sum of (a) 85% of our ordinary income for that year, (b) 95% of our capital gain net income for that year and (c) any undistributed taxable income from prior periods, we would have to pay a 4% excise tax on the excess of the required distribution over the amounts actually distributed.

We intend to satisfy the annual distribution requirements.

From time to time, we may not have sufficient cash or other liquid assets to meet the 90% distribution requirement due to timing differences between (a) when we actually receive income and when we actually pay deductible expenses and (b) when we include the income and deduct the expenses in arriving at our taxable income. If timing differences of this kind occur, to meet the 90% distribution requirement, we may find it necessary to arrange for short-term, or possibly long-term, borrowings or to pay dividends in the form of taxable stock dividends.

Under certain circumstances, we may be able to rectify a failure to meet the distribution requirement for a year by paying deficiency dividends to stockholders in a later year, which may be included in our deduction for dividends paid for the earlier year. Thus, we may be able to avoid being taxed on amounts distributed as deficiency dividends; however, we will be required to pay interest based upon the amount of any deduction taken for deficiency dividends.

**Table of Contents**

**Failure to Qualify as a REIT**

If we fail to qualify for taxation as a REIT in any taxable year, and the relief provisions do not apply, we will have to pay tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates. We will not be able to deduct distributions to stockholders in any year in which we fail to qualify, nor will we be required to make distributions to stockholders. In this event, to the extent of current and accumulated earnings and profits, all distributions to stockholders will be taxable to the stockholders as dividend income (which may be subject to tax at preferential rates) and corporate distributees may be eligible for the dividends received deduction if they satisfy the relevant provisions of the Code. Unless entitled to relief under specific statutory provisions, we will also be disqualified from taxation as a REIT for the four taxable years following the year during which qualification was lost. We might not be entitled to the statutory relief described in this paragraph in all circumstances.

**Tax Basis of Assets**

Sunstone Hotel Partnership has made an election under Section 754 of the Code. Accordingly, our proportionate share of the basis of the assets held by Sunstone Hotel Partnership were stepped up to fair market value to the extent of the portion of our interest in Sunstone Hotel Partnership that was purchased from Sunstone Hotel Investors, L.L.C., Sunstone/WB Hotel Investors IV, LLC, Sunstone/WB Manhattan Beach, LLC and WB Hotel Investors, LLC in connection with our initial public offering (as opposed to the portion that was purchased directly from Sunstone Hotel Partnership in connection with the initial public offering of our common stock in 2004). Our remaining share of Sunstone Hotel Partnership s basis in its assets, however, was not adjusted in connection with the initial public offering and was generally less than the fair market value of the hotels as of the date of the initial public offering. Furthermore, we have used and intend to continue to use the traditional method for making allocations under Section 704(c) of the Code as opposed to the curative or remedial method for making such allocations. As a result, (a) our depreciation deductions with respect to our hotels will be less than the depreciation deductions that would have been available to us had our tax basis been equal to the fair market value of the hotels as of the date of the initial public offering and (b) we may recognize income upon a sale of an asset that is attributable to appreciation in the value of the asset that accrued prior to the date of the initial public offering.

**Taxation of U.S. Stockholders**

As used in this section, the term U.S. stockholder means a holder of common stock or preferred stock who, for United States Federal income tax purposes, is:

- a citizen or resident of the United States;
- a domestic corporation;
- an estate whose income is subject to United States Federal income taxation regardless of its source; or
- a trust if a United States court can exercise primary supervision over the trust s administration and one or more United States persons have authority to control all substantial decisions of the trust.

***Taxation of Dividends.*** As long as we qualify as a REIT, distributions made by us out of our current or accumulated earnings and profits, and not designated as capital gain dividends, will constitute dividends taxable to our taxable U.S. stockholders as ordinary income. Noncorporate U.S. stockholders will generally not be entitled to the tax rate applicable to certain types of dividends except with respect to the portion of any distribution (a) that represents income from dividends we received from a corporation in which we own shares (but only if such dividends would be eligible for the lower rate on dividends if paid by the corporation to its individual stockholders), or (b) that is equal to our real estate investment trust taxable income (taking into account the dividends paid deduction available to us) for our previous taxable year and less any taxes paid by us during our previous taxable year, provided that certain holding period and other requirements are satisfied at both

Table of Contents

the REIT and individual stockholder level. Noncorporate U.S. stockholders should consult their own tax advisors to determine the impact of tax rates on dividends received from us. Distributions of this kind will not be eligible for the dividends received deduction in the case of U.S. stockholders that are corporations. Distributions made by us that we properly designate as capital gain dividends will be taxable to U.S. stockholders as gain from the sale of a capital asset held for more than one year, to the extent that they do not exceed our actual net capital gain for the taxable year, without regard to the period for which a U.S. stockholder has held his common stock or preferred stock. Thus, with certain limitations, capital gain dividends received by an individual U.S. stockholder may be eligible for preferential rates of taxation. U.S. stockholders that are corporations may, however, be required to treat up to 20% of certain capital gain dividends as ordinary income.

To the extent that we make distributions not designated as capital gain dividends in excess of our current and accumulated earnings and profits, these distributions will be treated first as a tax-free return of capital to each U.S. stockholder. Thus, these distributions will reduce the adjusted basis (but not below zero) which the U.S. stockholder has in our common stock or preferred stock for tax purposes by the amount of the distribution. Distributions in excess of a U.S. stockholder s adjusted basis in his common stock or preferred stock will be taxable as capital gains.

Dividends authorized by us in October, November, or December of any year and payable to a stockholder of record on a specified date in any of these months will be treated as both paid by us and received by the stockholder on December 31 of that year, provided that we actually pay the dividend on or before January 31 of the following calendar year. Stockholders may not include in their own income tax returns any of our net operating losses or capital losses.

U.S. stockholders holding common stock or preferred stock at the close of our taxable year will be required to include, in computing their long-term capital gains for the taxable year in which the last day of our taxable year falls, the amount that we designate in a written notice mailed to our stockholders. We may not designate amounts in excess of our undistributed net capital gain for the taxable year. Each U.S. stockholder required to include the designated amount in determining the stockholder s long-term capital gains will be deemed to have paid, in the taxable year of the inclusion, the tax paid by us in respect of such stockholder s undistributed net capital gains. U.S. stockholders to whom these rules apply will be allowed a credit or a refund, as the case may be, for the tax they are deemed to have paid. U.S. stockholders will increase their basis in their common stock or preferred stock by the difference between the amount of the includible gains and the tax deemed paid by the stockholder in respect of these gains.

Distributions made by us and gain arising from a U.S. stockholder s sale or exchange of our common stock or preferred stock will not be treated as passive activity income. As a result, U.S. stockholders generally will not be able to apply any passive losses against that income or gain.

***Sale or Exchange of Common Stock or Preferred Stock.*** When a U.S. stockholder sells or otherwise disposes of our common stock, or preferred stock, the stockholder will recognize gain or loss for Federal income tax purposes in an amount equal to the difference between (a) the amount of cash and the fair market value of any property received on the sale or other disposition and (b) the holder s adjusted basis in the common stock, or preferred stock, for tax purposes. The gain or loss will be long-term gain or loss if the U.S. stockholder has held the common stock, or preferred stock, for more than one year. Long-term capital gain of a noncorporate U.S. stockholder is generally taxed at preferential rates. In general, any loss recognized by a U.S. stockholder when the stockholder sells or otherwise disposes of our common stock, or preferred stock, that the stockholder has held for six months or less, after applying certain holding period rules, will be treated as a long-term capital loss, to the extent of distributions received by the stockholder from us which were required to be treated as long-term capital gains.

***Redemption of Preferred Stock.*** Our preferred stock is redeemable by us under certain circumstances described in this prospectus supplement. Any redemption of our preferred stock for cash will be a taxable

**Table of Contents**

transaction for United States federal income tax purposes. If a redemption for cash by a United States Holder is treated as a sale or redemption of such preferred stock for United States federal income tax purposes, the holder will recognize capital gain or loss equal to the difference between the purchase price and the United States Holder s adjusted tax basis in the preferred stock redeemed by us. The gain or loss would be long-term capital gain or loss if the holding period for the preferred stock exceeds one year. The deductibility of capital losses may be subject to limitations.

The receipt of cash by a shareholder in redemption of the preferred stock will be treated as a sale or redemption for United States federal income tax purposes if the redemption:

- is not essentially equivalent to a dividend with respect to the holder under Section 302(b)(1) of the Code;

- is a substantially disproportionate redemption with respect to the holder under Section 302(b) (2) of the Code; or

- results in a complete termination of the holder s stock interest in Sunstone Hotel Investors under Section 302(b)(3) of the Code.

In determining whether any of these tests has been met, a holder must take into account not only preferred stock or any other class of our stock it actually owns, but also any of our stock regardless of class it constructively owns within the meaning of Section 318 of the Code (including stock that is owned, directly or indirectly, by certain members of the holder s family and certain entities (such as corporations, partnerships, trusts and estates) in which the holder has an equity interest as well as stock that may be acquired through options that it owns).

A distribution to a shareholder will be treated as not essentially equivalent to a dividend if it results in a meaningful reduction in the shareholder s stock interest (taking into account all shares owned, regardless of class or series) in Sunstone Hotel Investors. Whether the receipt of cash by a shareholder will result in a meaningful reduction of the shareholder s proportionate interest will depend on the shareholder s particular facts and circumstances. If, however, as a result of an redemption of preferred stock, a United States Holder whose relative stock interest (actual or constructive) in Sunstone Hotel Investors is minimal and who exercises no control over corporate affairs suffers a reduction in its proportionate interest in Sunstone Hotel Investors (including any ownership of stock constructively owned), the holder generally should be regarded as having suffered a meaningful reduction in its interest in Sunstone Hotel Investors.

Satisfaction of the substantially disproportionate and complete termination exceptions is dependent upon compliance with the respective objective tests set forth in Section 302(b)(2) and Section 302(b)(3) of the Code. A distribution to a shareholder will be substantially disproportionate if the percentage of our outstanding voting stock actually and constructively owned by the shareholder immediately following the redemption of preferred stock (treating preferred stock redeemed as not outstanding) is less than 80% of the percentage of our outstanding voting stock actually and constructively owned by the shareholder immediately before the redemption (treating preferred stock redeemed pursuant to the tender offer as outstanding), and immediately following the redemption the shareholder actually and constructively owns less than 50% of the total combined voting power of Sunstone Hotel Investors. Because our preferred stock is nonvoting stock, a holder would have to reduce such holder s holdings in any of our classes of voting stock (if any) to satisfy this test.

A distribution to a shareholder will result in a complete termination if either (1) all of the preferred stock and all other classes of our stock actually and constructively owned by the shareholder are redeemed or (2) all of the preferred stock and our other classes of stock actually owned by the shareholder are redeemed or otherwise disposed of and the shareholder is eligible to waive, and effectively waives, the attribution of our stock constructively owned by the shareholder in accordance with the procedures described in Section 302(c)(2) of the Code.

**Table of Contents**

Any redemption may not be a redemption of all of our preferred stock. If we were to redeem less than all of the preferred stock, your ability to meet any of the three tests described above might be impaired. In consulting with their tax advisors, shareholders should discuss the consequences of a partial redemption of our preferred stock on the amount of our stock actually and constructively owned by such holder required to produce the desired tax treatment.

If a United States Holder s receipt of cash attributable to a redemption of our preferred stock for cash does not meet one of the tests of Section 302 of the Code described above, then the cash received by such holder in the tender offer will be treated as a dividend and taxed as described above.

***Backup withholding.*** We will report to our U.S. stockholders and the IRS the amount of dividends paid during each calendar year, and the amount of tax withheld, if any. Under the backup withholding rules, backup withholding may apply to a stockholder with respect to dividends paid unless the holder (a) is a corporation or comes within certain other exempt categories and, when required, demonstrates this fact, or (b) provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with applicable requirements of the backup withholding rules. The IRS may also impose penalties on a U.S. stockholder that doe