NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

June 20, 2016

The Honorable Orrin Hatch
Chairman
Senate Committee on Finance
219 Dirksen
Washington, D.C. 20510

The Honorable Ron Wyden
Ranking Member
Senate Committee on Finance
219 Dirksen
Washington, D.C. 20510

The Honorable Kevin Brady
Chairman
House Committee on Ways & Means
1102 Longworth
Washington, D.C. 20515

The Honorable Sander Levin
Ranking Member
House Committee on Ways & Means
1102 Longworth
Washington, D.C. 20515

Re: Technical Corrections Act of 2016

Gentlemen:

The National Association of Real Estate Investment Trusts (NAREIT)[1] welcomes the opportunity to provide comments on H.R. 4891 and S. 2775, the Technical Corrections Act of 2016 (the Technical Corrections Act).

NAREIT's comments relate to section 2 of the Technical Corrections Act, "Amendments relating to Protecting Americans from Tax Hikes Act of 2015" (the PATH Act), which was enacted as part of Pub. Law 114-113, the "Consolidated Appropriations Act, 2016," and signed into law on December 18, 2015. Among other things, the PATH Act included legislative provisions derived from the "Update and Streamline REIT Act" (H.R. 5746, introduced in 2012, the U.S. REIT Act).

As further described below, in order to maintain their status as REITs, companies must satisfy certain quarterly and annual asset and gross income tests. Since 1976, rental income from ancillary personal property rented with real property (like appliances in an apartment) has been treated as rents from real property for purposes of the REIT gross income tests. The PATH Act reduced the regulatory recordkeeping burden on REITs by conforming the treatment of ancillary personal property as a real estate asset for purposes of the REIT asset tests to the treatment of ancillary personal property for purposes of the REIT gross income tests.

[1] NAREIT®, the National Association of Real Estate Investment Trusts®, is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

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NAREIT requests a technical correction that would treat gains from ancillary personal property rented alongside real property as real estate-related gains, consistent with the Congressional intent of streamlining compliance with the REIT gross income and asset tests when ancillary personal property is leased with real property.

DISCUSSION

A. REIT Gross Income and Asset Tests

Under section 856(c)(3) of the Internal Revenue Code (the Code),[2] at least 75% of a REIT's annual gross income must be from real estate-related sources. Additionally, under section 856(c)(2), at least 95% of a REIT's annual gross income must be from either the 75% sources or specified sources of passive income, such as non-real estate interest and dividends. Real estate-related income that qualifies under sections 856(c)(2) and (c)(3) includes "rents from real property" (sections 856(c)(2)(C) and (c)(3)(A)) and gains from the sale or other disposition of a real estate asset (sections 856(c)(2)(H) and (c)(3)(H)).

Under section 856(d)(1)(C), the term "rents from real property" includes rents attributable to personal property leased under, or in connection with, a lease of real property so long as the rent attributable to such personal property does not exceed 15% of the total rent under the lease (referred to as the Ancillary Personal Property Rule). Congress enacted this rule forty years ago as an acknowledgment that amounts paid for the use of space remain rents from real property even though the tenant also rents a *de minimis* amount of associated personal property as part of the transaction:

> Generally, under prior law, where an amount of rent is received with respect to property which consists of both real and personal property, such as a furnished apartment building, an apportionment of the rent was required. Only that part of the rent which was attributable to real property was treated as qualifying income for purposes of the income source tests.
>
> The Congress believes that where rents attributable to such personal property are an insubstantial amount of the total rents received or accrued under a lease covering both real and personal property, the rents should be treated as qualified income.[3]

The Ancillary Personal Property Rule is a matter of common sense. When a tenant rents a unit in an apartment building, he or she is probably not even conscious that the rental includes personal property such as kitchen appliances, rugs and drapes, because the rent is being paid to occupy the apartment unit, which is undeniably real estate. The same is true with the rent paid to occupy

[2] Unless otherwise indicated herein, all references to a "section" shall be to a section of the Code.
[3] General Explanation of the Tax Reform Act of 1976, JCS-33-76 at 454-455 (Dec. 29, 1976).

other types of real estate. Further, this rule provides a measure of administrative convenience to a REIT,[4] avoiding the need to determine the amount of rent per lease attributable to such *de minimis* amounts of ancillary personal property and then account separately for that amount. For REITs that own hundreds or thousands of parcels of property and lease portions of those properties pursuant to thousands or tens of thousands of leases, this provision is very helpful.

Additionally, under section 856(c)(4)(A), generally at least 75% of the value of a REIT's total assets quarterly must be from, *inter alia*, "real estate assets", including interests in "real property." However, prior to the PATH Act, even *de minimis* amounts of personal property that generated rents from real property under the Ancillary Personal Property Rule had to be accounted for as personal property for purposes of the REIT 75% asset test. Thus, the *de minimis* personal property had to be separately valued by the REIT in order to demonstrate compliance with the REIT 75% asset test.

B. PATH Act Conformity of REIT 75% Asset Test with Ancillary Personal Property Rule for REIT Gross Income Tests:

The PATH Act added section 856(c)(9) to the Code, which provides that:

> (9) Special rules for certain personal property which is ancillary to real property.
>
> > (A) Certain personal property leased in connection with real property.
> > Personal property shall be treated as a real estate asset for purposes of paragraph (4)(A) [that is, the REIT 75% asset test] to the extent that rents attributable to such personal property are treated as rents from real property under subsection (d)(1)(C) [that is, the Ancillary Personal Property Rule].

The PATH Act thus enacted a helpful improvement to the REIT rules concerning ancillary personal property. After the PATH Act, the value of ancillary personal property owned and leased in connection with the lease of real property is considered a "real estate asset," mirroring the treatment of the rental income from ancillary personal property as "rents from real property." This improvement lets REITs streamline compliance with both the REIT gross income tests and the REIT 75% asset test by eliminating the need to separately account for ancillary personal property, which, by definition, is of *de minimis* value when compared with the value of the associated real property (for example, the value of the window coverings in office buildings compared with the value of the buildings).

The new rule continues Congress' common sense application of the REIT rules, causing a *de minimis* amount of personal property associated with a real estate lease to be considered a real estate asset for purposes of both the REIT gross income tests and the REIT 75% asset test.

[4] Congress cited the "ease of administration" as the basis for carrying out this rule. *Id.* at 455.

C. Technical Issue: The Gain from Ancillary Personal Property Leased with Real Property Is Not Referenced in All Required Places in the PATH Act

Despite the discussion in the previous section, and apparently in conflict with the Congressional intent (as described above) to treat small amounts of personal property associated with renting real estate as real estate assets in order to streamline REIT compliance with the REIT gross income tests and the REIT 75% asset test,[5] gain from the sale or disposition of such ancillary personal property (even when sold or disposed of along with the associated real property) is apparently not treated as gain from the sale or disposition of a real estate asset, even though such ancillary personal property itself is otherwise treated as a real estate asset. That incongruous result occurs because the PATH Act's change to section 856(c)(9) provides only that ancillary personal property shall be treated as a "real estate asset" for purposes of the REIT 75% asset test in section 856(c)(4)(A), but the change does not include the REIT gross income tests of sections 856(c)(2) and (c)(3), (and specifically sections 856(c)(2)(H) and (c)(3)(H), which is where the gain from the sale or disposition of a real estate asset is addressed).

D. *Recommendation: Treat Gain From Ancillary Personal Property as Gain from the Sale or Disposition of a Real Estate Asset for REIT Gross Income Tests Purposes*

In order to fulfill the Congressional intent of treating *de minimis* amounts of personal property associated with renting real estate as real estate assets and thus streamline compliance with the REIT gross income tests and the REIT 75% asset test, NAREIT requests a technical correction providing that gain from the sale or disposition of ancillary personal property be treated as gain from the sale or disposition of the associated real estate asset. This provision could be included by deleting the terms "paragraph (4)(A)" in section 856(c)(9)(A) and substituting the terms "paragraphs (2)(H), (3)(H), and (4)(A)."[6]

A Joint Tax Committee publication[7] defines a technical correction as legislation "that is designed to correct errors in existing law in order to fully implement the intended policies of previously enacted legislation. The principal factor in determining whether a provision is technical is the original intent of the underlying legislation. Once it is determined that the existing statute does not properly implement legislative intent, and that the proposed change conforms to and does not alter the intent, the provision is deemed to be technical."

[5] "If enacted, [this provision] would increase flexibility and remove certain redundant and unnecessary restrictions on REIT activities, in order to enable REITs to continue to achieve the goals on behalf of their shareholders set for them by Congress over fifty years ago." Remarks of Representative Pat Tiberi, Cong. Rec. E820 (May 16, 2012).
[6] This technical change would be consistent with the rule in section 897(c)(6)(B), which treats personal property associated with real estate rentals as gain from the sale of real property under the FIRPTA rules.
[7] Joint Committee on Taxation, ''Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation'' (JCX-1-05) 34, (Feb. 2, 2005), available at: http://www.jct.gov/x-1-05.pdf.

This proposed correction would correct the omission in section 856(c)(9) of sections 856(c)(2)(H) and (c)(3)(H) in order to fully implement the intended policy of the PATH Act. The existing statute, as passed, does not fully implement Congressional intent and could in fact lead to confusion, as REITs will treat both rental income and the value of ancillary personal property as "rents from real property" and included in the value of a "real estate asset," respectively, and may thus assume that they should similarly treat gains from the sale or disposition of such ancillary personal property as gains from the sale or disposition of a real estate asset. The proposed change would eliminate that confusion, confirm the treatment of ancillary personal property as a real estate asset throughout section 856(c), and thus implement Congressional intent.

We would be pleased to further discuss these comments if you believe it would be helpful. Please feel free to please contact me at (202) 739-9408, or tedwards@nareit.com; Cathy Barré, NAREIT's Senior Vice President, Policy & Politics, at (202) 739-9422, or cbarre@nareit.com; or Dara Bernstein, NAREIT's Vice President and Senior Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

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