NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

July 19, 2016

VIA ELECTRONIC SUBMISSION [www.regulations.gov]

Internal Revenue Service
CC:PA:LPD:PR (REG-126452-15)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Certain Transfers of Property to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs); Final, Temporary and Proposed Regulations (REG-126452-15) (the 2016 Regulations)

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts (NAREIT) appreciates the opportunity to offer our comments and recommendations to the Treasury Department and Internal Revenue Service (the IRS) with respect to the 2016 Regulations[1], relating to conversions of entities from, and transfers of assets by, C corporations[2] to REITs or RICs[3] under section 337(d).[4] NAREIT requests a public hearing on these final, temporary, and proposed regulations.

NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. We represent a large and diverse industry including equity REITs, which own commercial properties, mortgage REITs, which invest in mortgage securities, REITs traded on major stock exchanges, public non-listed REITs and private REITs. Public U.S. REITs collectively own nearly $2 trillion of real estate assets and, by making investment in commercial real estate available in the form of stock, our REIT members enable all investors – importantly, small investors – to achieve what once only large institutions and the wealthy could.

As further described below, the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"), enacted on December 18, 2015, made permanent the 5-year period for the recognition of gain under section 1374, which had been

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[1] *See* T.D. 9770, 81 Fed. Reg. 36793; *see also* the parallel proposed regulations in 81 Fed. Reg. 36816.

[2] Although REITs and RICs clearly are C corporations (*see, e.g.,* I.R.C. § 1361(a)(2)), for purposes of this letter "C corporations" refers to C corporations other than REITs and RICs.

[3] Although the 2016 Regulations address both REITs and RICs, this submission will address only REITs.

[4] Unless otherwise provided, any reference to "section" in this letter shall be to a section of the Internal Revenue Code of 1986, as amended (the Code).

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reduced from 10 years in previous years on a temporary basis.[5] Additionally, the previous final regulations under section 337(d) (the "2013 Regulations"), generally provided that, when a REIT disposes of appreciated property after converting to a REIT from a C corporation or acquiring property from a C corporation (a Conversion Transaction), the REIT must apply the rules of section 1374 for a specified built-in gain recognition period (currently five years) and pay tax at the corporate level on any built-in gain except to the extent that the C corporation either recognizes gain on the transaction or elects "deemed sale" treatment to recognize and pay tax on the gain from the transaction. The PATH Act also generally eliminated the ability of C corporations to participate in tax-free REIT spin-offs under section 355, either as a distributing corporation or a controlled corporation. The PATH Act further restricted REIT spin-offs by prohibiting a C corporation that has engaged in a tax-free spin-off from electing to be a REIT within 10 years of the spin-off.

The 2016 Regulations provide that the built-in gain recognition period under section 1374 is 10 years for REITs. Additionally, the 2016 Regulations generally require deemed sale treatment (with no ability to elect section 1374 treatment) for any C corporation that engages in a Conversion Transaction within 10 years of a tax-free spin-off that involves the converting C corporation (the Automatic Deemed Sale Rule).[6]

EXECUTIVE SUMMARY

NAREIT believes that the 2016 Regulations are inconsistent with Congress' intent in the PATH Act in certain specific respects. Accordingly—

(1) The 2016 Regulations show no rational basis for discriminating against REITs as compared to S corporations with respect to *General Utilities*[7] repeal issues, and therefore NAREIT respectfully recommends that the 2016 Regulations be immediately withdrawn and then modified to: i) maintain parity between S corporations and REITs; and ii) define "recognition period" for REITs with reference to the 5-year recognition period of section 1374 for S corporations, both as provided by the PATH Act.

(2) NAREIT respectfully recommends that the 2016 Regulations:

a) be modified so that the Automatic Deemed Sale Rule only applies when a Conversion Transaction and the accompanying spin-off are part of the same plan;

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[5] *See* section 1374(d)(7)(A).

[6] On June 27, 2016, the Treasury Department and the IRS issued a technical correction to the effective date of the 2016 Regulations, which correction clarifies that the regulations do not apply to spin-offs that occurred before December 7, 2015 (*i.e.*, before the effective date of the REIT spin-off rules contained in the PATH Act). This technical correction aligns the 2016 Regulations with the PATH Act and makes it clear that, as under the PATH Act, an entity that engaged in a tax-free spin-off before December 7, 2015, can convert to a REIT or be acquired by a REIT without being subject to immediate tax on all of the built-in gain in its assets. NAREIT appreciates the Treasury Department's and the IRS' quick correction.

[7] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 [16 AFTR 1126] (1935).

b) be modified so that the result of application of the Automatic Deemed Sale Rule is limited to the built-in gain at the time the spin-off transaction in any assets that both: i) are held at the time of the spin-off transaction by the distributing corporation, the controlled corporation, or a member of the separate affiliated group (SAG) (within the meaning of section 355(b)(3)(B)) of either of the distributing corporation or the controlled corporation; and, ii) are held at the time of the Conversion Transaction by the corporation engaged in the Conversion Transaction;

c) be modified so that the Automatic Deemed Sale Rule does not apply if both the distributing corporation and controlled corporation in a tax-free spin-off transaction are REITs immediately after the transaction, consistent with a similar exception under PATH Act; and,

d) adopt a two-year presumption rule, under which any Conversion Transaction completed within two years after a spin-off transaction is presumed to be part of a plan with the spin-off transaction, and any Conversion Transaction not completed within that period is presumed not to be part of a plan with the spin-off transaction.

DISCUSSION

A. Background

1. Prior to the 2016 Regulations

a. *The "Built-in Gains" Tax*

Under section 1374, when a C corporation that has unrealized (*i.e.*, built-in) gain in its assets converts to an S corporation, the S corporation—though normally not subject to entity-level tax—is required to pay corporate-level tax on any built-in gains that are recognized in a taxable transaction within a "recognition period." When enacted in 1986, the recognition period was 10 years. For 2009 and 2010, the recognition period was defined as the 7-year period beginning on the effective date of the S election, plus the remainder of the final taxable year, rather than the then 10-year period otherwise provided by section 1374(d)(7). For 2011, the recognition period was reduced to the 5-year period beginning on the effective date of the S election, plus the remainder of the final taxable year.[8] For taxable years beginning in 2012, 2013, and 2014, the recognition period was further reduced to the 5-year period beginning on the effective date of the S election.[9] The PATH Act made this 5-year recognition period permanent.[10]

[8] *See* section 1374(d)(7)(B) prior to passage of the PATH Act. *See also* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1251 and Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2014(a).

[9] *See* section 1374(d)(7)(C) prior to passage of the PATH Act.

[10] *See* section 1374(d)(7)(A).

Congress repealed the *General Utilities* doctrine in the Tax Reform Act of 1986. The Tax Reform Act of 1986 included section 337(d), which provided authority for the IRS and Treasury Department to promulgate

> such regulations as may be necessary or appropriate to carry out the purposes of the amendments made … by the Tax Reform Act of 1986, including -(1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter)....

The Technical and Administrative Revenue Act of 1988 (TAMRA) amended section 337(d) to add the words "or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity," after "subchapter)". Following TAMRA's enactment, in 1988 the IRS issued Notice 88-19[11] that provided guidance to taxpayers that C corporations converting to or merging into REITs should use the same built-in gain recognition period as S corporations. This parallel treatment of S corporations and REITs has been a bedrock feature of federal income tax law for nearly 30 years.[12] In the most recent guidance, the 2013 Regulations, contained in Treas. Reg. § 1.337(d)-7, generally impose the rules of section 1374, including its definition of "recognition period," when a C corporation engages in a Conversion Transaction with respect to a REIT.[13] The legislative history of the PATH Act indicates that Congress understood that the recognition period for REITs was tied to the recognition period for S corporations,[14] and that Congress expected and intended the PATH Act's enactment of a permanent 5-year recognition period to apply to REITs.[15]

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[11] Notice 88-19, 1988-1 C.B. 486.

[12] Treas. Reg. §§ 1.337(d)-5, -6 and -7.

[13] The IRS first incorporated section 1374 into the regulations under section 337(d) in 2000, which regulations have been updated numerous times since.

[14] *See* the Technical Explanation of the PATH Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029, Rules Committee Print 114-40 (December 17, 2015) (the PATH Act Committee Report) at p. 43 ("A regulated investment company ('RIC') or a real estate investment trust ('REIT') that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of section 1374 as if the RIC or REIT were an S corporation, unless the relevant C corporation elects 'deemed sale' treatment. The regulations include an express reference to the 10-year recognition period in section 1374."). *See also* the General Explanation of the Tax Legislation Enacted in 2015, Joint Committee on Taxation (March 2016) (the JCT Explanation) at p. 149.

[15] *See* the PATH Act Committee Report explanation of section 18 at p. 43 ("Under current Treasury regulations…the five-year recognition period…also would apply to REITs and RICs that do not elect 'deemed sale' treatment."). Representative David Reichert (R-WA), speaking in the House of Representatives regarding S corporation reform, recently reiterated that Congress intended for the PATH Act to provide a permanent 5-year gain recognition period for S corporations, REITs, and RICs:

> With broad bipartisan support in December, Congress passed the Protecting Americans from Tax Hikes (PATH) Act that provided permanent built-in gains tax relief for S Corporations. The legislative history of this provision makes clear that Congress intended this permanent relief for built-in gains to also apply to Real Estate Investment Trusts (REITs) and mutual funds.

One effect of the 2013 Regulations is that, in those situations when the PATH Act does not prevent a C corporation from converting to a REIT in connection with a tax-free spin-off—for example, when a distributed C corporation is acquired by a REIT after the spin-off—the REIT is subject to the 5-year built-in gain recognition period on the acquired assets.

b. *REIT Spin-offs*

In general, a corporation is required to recognize gain on the distribution of property (including the stock of a subsidiary) to its shareholders as if the corporation had sold the property for its fair market value,[16] and the shareholders receiving the property are generally treated as having received a taxable distribution.[17] Under section 355, however, there is no tax to a corporation (a distributing corporation) or its stockholders when the corporation distributes the stock of another corporation that it controls (a controlled corporation), if certain requirements are met.

Prior to the enactment of the PATH Act on December 18, 2015, the IRS had issued a revenue ruling and several favorable private letter rulings that a spin-off involving a REIT could qualify under section 355.[18] Consequently, a C corporation that held assets suitable for a REIT could contribute those assets to a subsidiary that would elect REIT status after the spin-off and then distribute the subsidiary stock to its shareholders tax free. Following the spin-off, if during the built-in gain applicable recognition period the REIT disposed of assets with built-in gains it held at the time of the spin-off in a taxable transaction, it would generally be subject to corporate-level tax.

The PATH Act eliminated the ability of C corporations to participate in tax-free REIT spin-offs, either as a distributing corporation or a controlled corporation because it made tax-free treatment under section 355 generally unavailable if either the distributing corporation or the controlled corporation is a REIT.[19] This general rule does not apply if both the distributing corporation and the controlled corporation are REITs immediately after the distribution (the "REIT-Only Spin-Off Exception").[20] The PATH Act further restricts REIT spin-offs by prohibiting a C corporation that has engaged in a tax-free spin-off, again as either a distributing corporation or a controlled

See 162 Cong. Rec. E1140 (July 15, 2016 Daily Edition). Representatives Reichert and Ron Kind (D-WI) were the original co-sponsors of the bills introduced in the past several Congresses to make the 5-year built-in gain recognition period permanent that were eventually incorporated into the PATH Act. *See, e.g., infra* note 41.

[16] Section 311(b).

[17] Section 301(c).

[18] *See, e.g.*, Rev. Rul. 2001-29, 2001-1 C.B. 1348 (ruling that a REIT can satisfy the "active business" requirement of section 355(b) through rental activities); PLR 201607003 (Nov. 5, 2015); PLR 201528006 (July 16, 2014); PLR 201411002 (Dec. 13, 2013); PLR 201407005 (Nov. 13, 2013); PLR 201340009 (Apr. 8, 2013); PLR 201337007 (Sept. 28, 2012).

[19] Section 355(h)(1)

[20] Section 355(h)(2)(A).

corporation (or either such entity's "successor"), from electing to be a REIT within 10 years of the spin-off.[21] The PATH Act allows, however, for a C corporation to elect REIT status and spin-off a controlled taxable REIT subsidiary, provided that the spin-off occurs at least 3 years after the REIT conversion (the "TRS Spin-Off Exception").[22] Additionally, the PATH Act does not prevent a C corporation that participated in a spin-off transaction from being acquired by a new or existing REIT, except to the extent the REIT elects to be a REIT within 10 years of the spin-off and the REIT is treated as a successor of the C corporation. The PATH Act does not provide the meaning of "successor" in this context.[23]

2. The 2016 Regulations

a. *Built-in Gains Tax Recognition Period*

The 2016 Regulations provide that the "recognition period" for purposes of the REIT built-in gains tax is not defined by reference to the recognition period of section 1374, which is contrary to the policy that has been in place since the tax was first added to the Code in 1988 (via the 2013 Regulations, all prior regulations and Notice 88-19), and which is contrary to Congressional expectation and intent when it permanently set the recognition period at five years in the PATH Act. Instead, effective August 8, 2016, the 2016 Regulations provide that the recognition period is a 10-year period beginning with the date of a Conversion Transaction.

b. *Deemed Sale Treatment*

Under the 2016 Regulations, the Automatic Deemed Sale Rule imposes significant additional restrictions on REIT spin-off transactions by requiring deemed sale treatment (with no ability to elect section 1374 treatment) for any C corporation that engages in a Conversion Transaction within 10 years of a spin-off that involves the converting C corporation.[24] Consequently, a C corporation that converts to a REIT, or transfers assets to a REIT, within 10 years of having participated in a tax-free spin-off is generally required under the 2016 Regulations to recognize gain and (subject to limitations) loss as if it had sold all of the transferred assets at their fair market value immediately prior to the Conversion Transaction. Additionally, the 2016 Regulations provide that if a REIT participates in a tax-free spin-off within 10 years of having engaged in a Conversion Transaction, the REIT must recognize any remaining built-in gain subject to section 1374 treatment in the year of the spin-off.[25]

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[21] Section 856(c)(8).

[22] Section 355(h)(2)(B).

[23] Letter from Tony M. Edwards, Exec. Vice President and Gen. Counsel, NAREIT, to the IRS (May 16, 2016) (NAREIT requested guidance on the meaning of "successor" in this context).

[24] Treas. Reg. § 1.337(d)-7T(c)(6).

[25] Treas. Reg. § 1.337(d)-7T(b)(4)(i). Technically, a REIT that participates in a spin-off within 10 years after a Conversion Transaction is not subject to the Automatic Deemed Sale Rule. Instead, the REIT's net recognized built-in gain in the year of the spin-off is the amount of its net unrealized built-in gain limitation, as defined in Treas. Reg. § 1.1374-2(a)(3). The effect, however, is practically the same as if the Automatic Deemed Sale Rule applied, insofar

The 2016 Regulations are overly and unnecessarily broad in defining when a C corporation has been involved in a spin-off for purposes of imposing deemed sale treatment on a Conversion Transaction.[26] In particular, deemed sale treatment is imposed if either the C corporation itself or any member of the C corporation's SAG participated in a spin-off, either as the distributing corporation or as the controlled corporation. Additionally, the 2016 Regulations provide that references to controlled and distributing corporations include any predecessor or successor of such corporation.[27] For this purpose, "predecessor" and "successor" are defined to "include" entities that have engaged in certain tax-free transactions in which one entity succeeds to the tax attributes of the other entity under section 381 (for example, tax-free reorganizations and liquidations).

The excessively sweeping scope and effect of these provisions can be illustrated with the following example. Suppose that:

- Two real estate C corporations (BigCo A and BigCo B) each hold assets worth $1 billion with $0 basis.
- BigCo A owns 100% of the stock of a subsidiary C corporation (Sub 1) holding assets worth $20 million with $0 basis.
- Sub 1 owns 100% of the stock of a subsidiary C corporation (Sub 2) holding assets worth $10 million with $0 basis.
- In Year 1, BigCo A spins off Sub 1 in a tax-free transaction under section 355.
- In Year 3, BigCo B acquires Sub 2 in a tax-free transaction under section 381, at time when BigCo B has no plans to convert to a REIT.
- In Year 9 (*i.e.*, 6 years after BigCo B's acquisition of Sub 2 but within 10 years of the spin-off of Sub 1), BigCo B converts to a REIT

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as the REIT is required to recognize any remaining gain that would otherwise be deferred under the section 1374 treatment rule. References herein to the "Automatic Deemed Sale Rule" accordingly refer to the treatment of a REIT that participates in a spin-off in the period either 10 years before or after a Conversion Transaction.

Proposed regulations issued at the time of the 2016 Regulations would also apply the Automatic Deemed Sale Rule to property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of property subject to section 1374. *See* Prop. Treas. Reg. § 1.337(d)-7(a)(2)(vii). For example, if a C corporation converts to a REIT and thereafter exchanges certain properties for like-kind properties under section 1031, the acquired properties would be subject to the Automatic Deemed Sale Rule if the REIT were to be treated as engaged in a spin-off transaction during the built-in gain recognition period.

[26] The broadness of the 2016 Regulations seems particularly unnecessary in light of the recently proposed regulations under section 355. *See* REG-134016-15 (July 15, 2016). If finalized, these regulations would further limit the ability of corporations holding assets suitable to be held in a REIT to engage in tax-free spin-offs. *See* Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(C).

[27] Treas. Reg. § 1.337(d)-7T(f)(2) ("Predecessors and successors include corporations which succeed to and take into account items described in section 381(c) [(such as earnings and profits)] of the distributing corporation or the controlled corporation, and corporations having such items to which the distributing corporation or the controlled corporation succeeded and took into account.").

Under the PATH Act, if Sub 1 had converted to a REIT in connection with its Year 1 spin-off, the maximum amount of built-in gain subject to tax on the spin-off would have been $20 million, which equals the built-in gain on the assets of Sub 1. Under the 2016 Regulations, however, Sub 2 has been virally "tainted" by Sub 1's activities in Year 1. Accordingly, BigCo B's tax-free acquisition of relatively tiny Sub 2 in Year 3 qualifies BigCo B as the "successor" to an entity (Sub 2) whose SAG member (Sub 1) had undergone a related tax-free spin-off within 10 years before the REIT conversion of its "successor". Therefore, the 2016 Regulations would force BigCo B to pay tax on the built-in gain on its entire $1.01 billion of assets (the $1 billion BigCo B owned in Year 0 plus the $10 million of the Sub 2 assets it acquired in Year 3) in Year 9.[28] As this example illustrates, under the 2016 Regulations' excessive sweep, the tail can wag the dog.

The 2016 Regulations are designed to ensure that certain transactions are not used to circumvent the Congressional policy underlying the PATH Act, which is to eliminate the ability of C corporations to participate in tax-free REIT spin-offs.[29] However, the 2016 Regulations are disproportionate to that policy, affecting many more transactions than would be necessary to achieve that result, including presently uncontemplated transactions. In this example, if the spin-off of Sub 1 by BigCo A in Year 1 had been fully taxable, the maximum income tax owed to the fisc would likely have been $9.6 million (calculated using a 35% corporate tax plus a 20% tax to shareholders on the after-tax amount). However, neither BigCo A nor Sub 1 had any intent to convert any of its activities to a REIT, and neither did BigCo B when it acquired Sub 2 in Year 3. Six years later in Year 9, the maximum income tax owed by BigCo B under the 2016 Regulations could be at least $350 million (a 35% corporate tax on the $1.01 billion of built-in gain), which arises solely because of its acquisition of Sub 2 in Year 3.

[28] The 2016 Regulations contain certain ambiguous language that raises the possibility that the scope of the Automatic Deemed Sale Rule may be even broader than is illustrated by the example above. A number of uncertain issues would be raised if, as a variation of the example above:

1. BigCo B had not converted into a REIT but instead had merged into another C corporation (BigCo C) and then BigCo C converted into a REIT (*i.e.*, is BigCo C a "successor" to Sub 2?);
2. BigCo B had acquired the stock of Sub 2 in a transaction in which Sub 2 became part of BigCo B's SAG (*i.e.*, is the concept of SAG tested only at the time of the related spin-off or does it remain relevant for the entire 10-year period?); or,
3. BigCo B was acquired by a REIT in a fully taxable transaction (*i.e.*, given that Treas. Reg. § 1.337(d)-7T(f)(2) defines "predecessor" and "successor" to "include" entities that have engaged in certain tax-free transactions, so can other transactions or situations also cause companies to be "included" in "predecessor" and "successor"?).

NAREIT encourages the Treasury Department and the IRS to consider the types of difficult issues raised by these examples when evaluating both the recommendations contained in this letter and also the 2016 Regulations more generally.

[29] The Preamble to the 2016 Regulations state that "there is concern that corporations affiliated with the distributing corporation or the controlled corporation could be used to circumvent the Congressional policy implemented through section 311 of the PATH Act". 81 Fed. Reg. 36796. As the above example illustrates, the reach of the 2016 Regulations can disproportionately extend to existing REITs not affiliated with a distributing or controlled corporation other than engaging in an arm's length "old and cold" transaction many years after a spin-off.

Additionally, the 2016 Regulations effectively eliminate certain exceptions to the PATH Act's prohibition on tax-free spin-off transactions. As under the PATH Act, the Automatic Deemed Sale Rule does not apply if the TRS Spin-Off Exception applies. However, the 2016 Regulations narrow the scope of the REIT-Only Spin-Off Exception, without an apparent policy basis. The PATH Act does not prohibit tax-free REIT spinoffs if both the distributing corporation and the controlled corporation are REITs immediately after the distribution; the 2016 Regulations impose the Automatic Deemed Sale Rule unless both the distributing corporation and the controlled corporation are REITs immediately after the distribution and *remain* so for two years after the distribution.[30] For example, under the PATH Act, if a REIT spins off a subsidiary that immediately elects to the subject to tax as a REIT, the spin-off may qualify as tax-free under section 355. Under the 2016 Regulations, if the controlled corporation were to fail to qualify as a REIT in the next two years, both the distributing corporation and the controlled corporation would immediately be subject to the Automatic Deemed Sale Rule.

B. ***Recommendations***

1. Maintain REIT and S Corporation Parity for the Built-in Gain Recognition Period

NAREIT urges the IRS and Treasury Department to maintain the parity between S corporations and REITs that has existed for nearly three decades and to continue to define the built-in gain recognition period for REITs with reference to the 5-year recognition period of section 1374, as provided by the PATH Act. NAREIT believes that the 10-year recognition period of the 2016 Regulations is contrary to Congress' expectation and intent in the PATH Act and, furthermore, that there is no policy basis for REITs and S corporations to have different recognition periods. The government has not provided any rational basis to discriminate against REITs compared to S corporations with regard to *General Utilities* repeal issues. This is particularly inappropriate in light of the fact that S corporations regularly engage in the same rental activities as REITs.[31]

Following TAMRA's 1988 enactment, the IRS and Treasury Department quickly announced, in the first promulgation of guidance on the application of section 1374 to REITs, that the recognition period for purposes of the regulations under section 337(d) would be defined with reference to the recognition period for S corporations.[32] The initial regulations under section 337(d) and all subsequent regulations prior to the 2016 Regulations reaffirmed this position.[33]

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[30] *See* Treas. Reg. § 1.337(d)-7T(f)(3).

[31] *See, e.g.*, PLR 200250023 (Sept. 4, 2002); PLR 200134022 (May 30, 2001); PLR 200134023 (May 30, 2001); PLR 9718006 (Jan. 17, 1997).

[32] *See* Notice 88-19, *supra* note 11 ("The regulations will permit the transferee RIC or REIT to elect . . . to be subject to rules similar to the rules of section 1374 of the Code.").

[33] T.D. 8872, 2000-1 C.B. 639, amended by T.D. 8975, 2002-1 C.B. 379 and T.D. 9047, 2003-1 C.B. 676; T.D. 9047, 2003-1 C.B. 676; T.D. 9047, 2003-1 C.B. 676, amended by T.D. 9626, 78 Fed. Reg. 46805.

Moreover, the IRS issued private letter rulings applying the S corporation section 1374 recognition period to REITs.[34]

Most importantly, the legislative history to the PATH Act indicates that Congress similarly understood that the recognition period for REITs is tied to the recognition period for S corporations.[35] Indeed, Congressional intent with respect to REIT parity with S corporations can be traced back many years with respect to the 5-year recognition period.

The Family and Business Tax Cut Certainty Act of 2012 was reported out of the Senate Finance Committee in 2012 and included a provision to reduce the recognition period in section 1374 from 10 to five years.[36] The accompanying committee report recognized that REITs and RICs "may elect to be subject to the rules of section 1374 as if the RIC or REIT were an S Corporation."[37] Later that year, Congress, being fully aware that REITs would have parity with S corporations on the recognition period for built in gains, passed legislation reducing the recognition period to 5 years for 2012 and 2013.[38]

Again, in 2014, being fully aware that REITs were subject to the same 5-year recognition period specified in section 1374 for S corporations, Congress and President Obama extended the 5-year recognition period for S corporations, REITs, and RICs for 2014.[39] In 2015, a similar one year extension of the 5-year recognition period was reported out of the Senate Finance Committee which acknowledged parity for REITs and RICs with S corporations under section 1374.[40] In early 2015 a bill, H.R. 629, passed the House of Representatives that would have made the 5-year recognition period permanent and was accompanied by a House Report that included an explanation of the parity afforded to REITs and RICs.[41] Finally, late in 2015 the PATH Act was enacted which, as those bills that came before it had done, reflected that Congress expected

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[34] *See, e.g.*, PLR 201537020 (May 22, 2015); PLR 201340009 (Apr. 8, 2013); PLR 201150023 (Sept. 12, 2011); PLR 200932018 (Apr. 14, 2009).

[35] See the PATH Act Committee Report at p. 43 ("A regulated investment company ('RIC') or a real estate investment trust ('REIT') that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of section 1374 as if the RIC or REIT were an S corporation, unless the relevant C corporation elects 'deemed sale' treatment. The regulations include an express reference to the 10-year recognition period in section 1374.").

[36] S. 3521, S. Rep. No. 208, 112th Cong., 2d Sess. p. 69 (2012).

[37] *Id*. at p. 70, note 165.

[38] The American Taxpayer Relief Act of 2012 (PL 112-240). *See* the General Explanation of the Tax Legislation Enacted in the 112th Congress, Joint Committee on Taxation (February 2013) at p. 186, note 497.

[39] Tax Increase Prevention Act of 2014 and the Stephen Beck, Jr., Achieving a Better Life Experience Act of 2014 (Pub. L. No. 113–295). *See* the General Explanation of the Tax Legislation Enacted in the 113th Congress, Joint Committee on Taxation (March 2015) at p. 181, note 488.

[40] Tax Relief Extension Act of 2015, S. 1946, S. Rep. No. 118, 114th Cong., 1st Sess. p.73 n.237 (2015).

[41] Permanent S Corporation Built-in Gain Recognition Period Act of 2015 to Accompany H.R. 629, H. Rep. No. 15, 114th Cong., 1st Sess. 5 (2015).

parity for REITs, RICs, and S corporations with respect to the permanent 5-year recognition period.[42]

Therefore, the 2016 Regulations' change of the recognition period from the recognition period for S corporations to 10 years runs counter to express Congressional intent. The Supreme Court has given authority to long-standing regulations when, as here, Congress was aware of regulations directly on point and could have enacted a change, but chose not to in reliance on the long-standing regulations.[43]

Perhaps most startling, given that REITs have been linked to S corporations for built-in gain recognition period purposes for nearly three decades and that REITs have been subject to a 5-year recognition period since 2011, it is unclear what urgent "good cause" motivated the issuance of the 2016 Regulations to "delink" the parity of REITs with S Corporations and increase the recognition period for REITs to 10 years without the benefit of the normal public comment period required by the Administrative Procedures Act.[44]

Furthermore, the Treasury Department and the IRS have not articulated, and NAREIT is unaware of, any rational policy basis for subjecting REITs to a longer recognition period than S corporations.[45] The general policy basis underlying section 1374 treatment is to achieve a balance between two competing objectives—i) preventing C corporations from circumventing the repeal of *General Utilities*[46] by converting themselves to a REIT or S corporation and then selling assets free of corporate tax, when such sale would have been subject to corporate tax if undertaken by a C corporation;[47] and, ii) ensuring that eligible businesses are not unduly prevented from enjoying the benefits of S corporation or REIT status on account of unnecessary "lock in" effects. In other words, section 1374 helps to ensure that C corporations can convert to S corporations or REITs for legitimate business reasons, while preventing them from converting merely to escape corporate taxation on the appreciation in their corporate assets.

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[42] *See supra* note 15.

[43] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 381-82 (1982). *See also* Wright v. City of Roanoke Redev. & Hous. Auth., 107 S. Ct. 766, 774 (1987); United States v. Board of Commissioners of Sheffield, Alabama, 435 U.S. 110, 134 (1978); Apex Hosiery Co. v. Leader, 310 U.S. 469, 489 (1940).

[44] 5 U.S.C. §§ 551-559.

[45] *See* T.D. 9770 (describing the shortening of the recognition period as a "clarifying amendment" that "the recognition period [for REITs] is no longer determined by reference to section 1374(d)(7)"). This seems to be a reach as the length of the recognition period under these regulations has always been clear.

[46] *See* H.R. Rep. No. 841, 99th Cong., 2nd Sess. 203 (1986) (Conf. Rep.); H.R. Rep. No. 426, 99th Cong., 1st Sess. 274-75 (1985).

[47] *See* T.D. 9770 ("In certain cases, General Utilities repeal could be circumvented if property of a C corporation becomes the property of a RIC or a REIT (converted property) by a transfer of the converted property from a C corporation to a RIC or a REIT or by the qualification of the C corporation as a RIC or a REIT (either, a conversion transaction). A conversion transaction could result in elimination of the corporate level of gain in the converted property, including gain from the sale of the property, because RICs and REITs generally are not subject to tax on income that is distributed to their shareholders.").

Parity is particularly appropriate in this instance because an S Corporation may be invested in real estate assets and engage in the exact same business activity as REITs. Indeed, there are multiple private letter rulings that acknowledge real estate S Corporations in the context of the S corporation converting to a REIT.[48]

As a practical matter, a C corporation that wishes to convert to a REIT already faces higher barriers than one that wishes to convert to an S corporation. While a C corporation may generally convert to an S corporation tax-free, a C corporation must make a "purging distribution" of its entire accumulated earnings and profits within a year of conversion to a REIT, which distribution is taxable to its shareholders.[49]

Furthermore, REITs must meet requirements related to the composition of their assets and income and must distribute all of their taxable income to their shareholders to avoid corporate-level tax, whereas an S corporation enjoys pass-through treatment regardless of its assets, income, or distribution practices. Additionally, under the PATH Act, a C corporation converting to a REIT is generally unable to engage in a tax-free spin-off transaction and, under the 2016 Regulations, may be subject to the Automatic Deemed Sale Rule in certain cases. These restrictions are inapplicable to S corporations. Given that C corporations already face these relatively higher barriers in converting to REITs, NAREIT believes that it is inequitable and inappropriate as a policy matter to subject REITs to a longer recognition period than S corporations for purposes of the built-in gains tax.

Most importantly, NAREIT believes that, in light of the Congressional policy underlying REITs, it is inappropriate to subject REITs to a longer recognition period for built-in gains than S corporations. Prior to the creation of modern REITs in 1960, generally only wealthy investors were able to invest in real estate without being subject to corporate tax, which they did through the use of partnerships. REITs were created in order to level the playing field for smaller

[48] *See supra* note 31.

[49] *See* section 857(a)(2)(B) (providing that a REIT may not have, at the close of the taxable year, any earnings and profits accumulated in any non-REIT year). We acknowledge that if an S corporation has accumulated earnings and profits (which may be the case when an S corporation converts from a C corporation), it risks losing its S corporation status if its "passive investment income," a term that includes rent, exceeds 25% of its gross receipts for three consecutive taxable years. *See* section 1362(d)(3). Additionally, the S corporation will be subject to corporate tax on the amount of its passive investment income that exceeds 25% of its gross receipts in any year in which it has accumulated earnings and profits. *See* section 1375(a). Accordingly, an S corporation will generally choose to "purge" its earnings and profits when it converts from a C corporation if it holds assets that are likely to generate large amounts of passive investment income. NAREIT believes that this similarity to REITs supports the longstanding practice of holding S corporations and REITs to the same recognition period for purposes of section 1374. Like a REIT, an S corporation holding real estate may convert from a C corporation and, provided it purges its accumulated earnings and profits, earn rental income that is not subject to tax at the entity level. In light of these similarities, NAREIT is unaware of any rationale that would support granting S corporations the relative advantage of being able to sell assets free of corporate-level tax that they held as a C corporation 5 years after conversion, while REITs must wait 10 years.

investors, thus increasing capital investment in real estate.[50] The 2016 Regulations' implementation of a 10-year recognition period for REITs would disadvantage ordinary investors by giving S corporations—which, unlike REITs, are often owned by a small group of wealthy individuals—the relative advantage of being able to sell assets tax-free 5 years after conversion, while REITs must wait 10 years.

For all the reasons stated above, NAREIT urges the IRS and Treasury Department to immediately withdraw the 2016 Regulations so as to maintain the parity between S corporations and REITs that has existed for nearly three decades and thus define "recognition period" for purposes of the 2016 Regulations by reference to the 5-year recognition period of section 1374, as provided by the PATH Act, and not the 10-year recognition of the 2016 Regulations.

2. Limit the Scope of the Automatic Deemed Sale Rule

NAREIT respectfully recommends that the IRS limit the scope of the Automatic Deemed Sale Rule in order to provide a fair and workable standard that achieves the purposes of the PATH Act. In the preamble to the 2016 Regulations, the Treasury Department and the IRS expressed concern that certain transactions could be used "to circumvent the Congressional policy implemented through section 311 of the PATH Act."[51] NAREIT appreciates the Treasury Department's desire "to prevent abuses of sections 355(h) [the rule generally preventing REIT spin-offs] and 856(c)(8) [the rule preventing entities that have engaged in spin-offs from electing REIT status]."[52] The Automatic Deemed Sale Rule, however, goes beyond the Congressional policy underlying these Code sections in a number of respects.

To better achieve the purposes of the PATH Act, we recommend that:

a. The Automatic Deemed Sale Rule only apply when the Conversion Transaction and the accompanying spin-off are part of the same plan.

b. The amount of gain recognized by a REIT as a result of application of the Automatic Deemed Sale Rule be limited to the built-in gain at the time of the spin-off transaction in any assets that: i) are held at the time of the spin-off transaction by the distributing corporation, the controlled corporation, or a member of the SAG of either the distributing corporation or the controlled corporation; and, ii) are held at the time of the Conversion

[50] *See* H.R. No. 2020, 86th Cong., 2d. Sess. (1960), at 3–4 ("The methods of investment [in REITs] constitute pooling arrangements whereby small investors can secure the advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangement; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.")

[51] *Supra* note 1.

[52] *Id*.

Transaction by the corporation engaged in the Conversion Transaction.[53] We recommend that the amount of such gain be adjusted to take into account the amount of any such built-in gain already recognized by the distributing corporation or the controlled corporation.

c. The Automatic Deemed Sale Rule not apply if both the distributing corporation and controlled corporation in a tax-free spin-off transaction are REITs immediately after the transaction, regardless of whether both the distributing corporation and controlled corporation remain REITs for two years.

d. The 2016 Regulations adopt a 2-year presumption rule, under which any Conversion Transaction completed within 2 years after a spin-off transaction is presumed to be part of a plan with the spin-off transaction, and, conversely, any Conversion Transaction not completed within that period is presumed not to be part of a plan with the spin-off transaction. We also recommend that rules and notifications similar to the safe harbor rules of section 355(e) and the disguised sale rules of section 707(a)(2)(B) be made applicable within this context.[54]

As discussed above, Congress generally intended for the PATH Act to render REIT spin-offs taxable.[55] We understand the 2016 Regulations are intended in part to address certain transactions that the Treasury Department and the IRS may consider abusive with respect to this purpose of the PATH Act. One such transaction that might be considered abusive is a C corporation spinning off a subsidiary C corporation just before one of those C corporations merges into or is acquired by a REIT in a tax-free acquisition. We agree that this type of transaction may be inconsistent with the spirit of the PATH Act if the spin-off were undertaken as part of plan to merge the distributing corporation or the controlled corporation into a REIT (especially one that was newly formed).[56] Such a plan would allow the distributing and

[53] In order to ensure that a corporation is properly subject to tax under the Automatic Deemed Sale Rule, NAREIT also recommends that if any asset held by the distributing corporation or controlled corporation (or a SAG member of either) is exchanged for a new asset in a transaction in which the basis of the new asset is determined (in whole or in part) by reference to the adjusted basis of the disposed asset, such new asset also should be treated as if it had been held by the distributing corporation or controlled corporation at the time of the spin-off transaction. The Code contains similar provisions regarding the application of section 1374 to property held by an S corporation the basis of which is determined by reference to section 1374 property. *See* section 1374(d)(6).

[54] *See also* Treas. Reg. §§ 1.355-7 and 1.707-3.

[55] *See* the JCT Explanation at 264 ("[section 311 of the PATH Act] makes a REIT generally ineligible to participate in a tax-free spin-off as either a distributing or controlled corporation under section 355.")

[56] With that said, we note that the PATH Act added section 856(c)(8), which provides:

> If a corporation was a distributing corporation or a controlled corporation (other than a controlled corporation with respect to a distribution described in section 355(h)(2)(A)) with respect to any distribution to which section 355 (or so much of section 356 as relates to section 355) applied, such corporation (and any successor corporation) s**hall not be eligible to make any election under paragraph (1)** for any taxable year beginning before the end of the 10-year period beginning on the date of such distribution.

controlled corporation's shareholders to spin off a subsidiary and have that subsidiary's assets held by a REIT—largely the same result as if the subsidiary had itself elected REIT status. In general, NAREIT believes that existing step-transaction principles provide the appropriate and adequate means to police these transactions.

We recognize, however, that the Treasury Department and the IRS may wish to create rules that give both the IRS and taxpayers greater clarity in determining whether a transaction should be within the scope of the regulations. We therefore understand the rationale for the Treasury Department's adoption of a bright-line "blackout" period during which the Automatic Deemed Sale Rule applies.

At 20 years, however, the 2016 Regulations' "blackout" period is too long to be an appropriate measure of the types of transactions that can reasonably be viewed as circumventing the PATH Act and the repeal of *General Utilities*. Instead, NAREIT's suggested approach of a 2-year presumption rule is not only more appropriate conceptually but also is consistent with the types of rules Congress and the Treasury Department have adopted in related contexts.

For example, REITs are generally prohibited from selling real estate held by the REIT as inventory, and proceeds from the sale of inventory by a REIT are subject to a 100% tax.[57] In order to provide taxpayers with a bright line rule to ensure that they are not treated as selling real estate as inventory, section 857 provides that property held by the REIT for at least two years (and satisfying other tests) can be treated as held for long-term investment, not inventory.[58] Prior to 2008, a REIT was required to hold property for at least 4 years in order to satisfy this safe harbor. In shortening the safe harbor period, Members of Congress expressed concern that 4 years was "simply too long a time in today's marketplace"[59] to use as a litmus test of a REIT's

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(Emphasis added).

A C corporation makes a REIT election by filing a Form 1120-REIT. The instructions to the Form 1120-REIT provide: "[t]he election to be treated as a REIT **remains in effect** until terminated, revoked, or the REIT has failed to meet the requirements of the statutory relief provisions." (Emphasis added). Thus, by its terms, the merger of a C corporation into an existing REIT does not constitute a new REIT election, and, therefore, is not technically affected by the PATH Act. For that reason, regulations that expand upon the PATH Act's provisions in order to prevent perceived abuses should be narrowly tailored.

[57] *See* sections 857(b)(6)(B)(iii) and 1221(a)(1).

[58] *See s*ections 857(b)(6)(C)(i) and 857(b)(6)(D)(i).

[59] *See, e.g.,* 153 Cong. Rec. S10849 (2007) (statement of Sen. Hatch) ("Congress has always wanted REITs to invest in real estate on behalf of their shareholders for the long term. Since the late 1970s, the mechanism to carry out these purposes has been a 100 percent excise tax on a REIT's gain from so-called 'dealer sales.' Because the 100 percent tax is so severe, Congress created a safe harbor under which a REIT can be certain that it is not acting as a dealer (and therefore not subject to the excise tax) if it meets a series of objective tests. This provision would update two of these safe harbor requirements. The current safe harbor requires a REIT to own property for at least four years. This is simply too long a time in today's marketplace. Further, four years departs too much from the most common time requirement for long-term investment—the one-year holding period for an individual's long-term capital gains. Accordingly, this provision uses a more realistic two-year threshold.")

intent to hold property for long-term investment, and that "a 2-year holding period better reflects current economic realities."

NAREIT believes that similar economic realities support the use of a 2-year presumption for purposes of determining whether a real estate corporation participating in a spin-off intends to engage in a REIT conversion as part of a plan with the spin-off.[60]

Furthermore, NAREIT's suggested approach is consistent with Congress' and the Treasury Department's approach in analogous scenarios. For example, section 355(e) was passed in part to prevent a transaction that Congress viewed as abusive in connection with tax-free spin-offs, when shareholders sold the majority of the controlled corporation's stock after the distribution.[61] Such a transaction allowed shareholders to reach a similar place as if the distributing corporation had sold the stock of the controlled corporation and distributed the sale proceeds to its shareholders, but without the layer of corporate tax imposed on the sale. In order to curb these transactions, section 355(e) requires a distributing corporation to recognize gain in connection with an otherwise tax-free spin-off if a 50% or greater interest in either the distributing or controlled corporation is acquired pursuant to a plan that includes the distribution. A plan is presumed to exist if a 50% or greater interest is acquired within the 2-year periods preceding and following the distribution.

Given the similarities in context between section 355(e) and the 2016 Regulations, NAREIT recommends a similar presumption be incorporated into the 2016 Regulations, as discussed above. As another example of how NAREIT's recommendation is consistent with analogous scenarios, the Treasury Department and the IRS have adopted a similar rule in the context of determining whether a partner and partnership have engaged in a disguised sale. The regulations under section 707 contain a 2-year presumption that if, within a 2-year period in either order, a partner transfers property to a partnership and the partnership transfers money to the partner, the transfers constitute a disguised sale of the property.[62]

The example above on page 7 illustrates the advantages of our recommended 2-year presumption. Under the 2016 Regulations, if BigCo B, a C corporation, acquires Sub 2 (a spun-off C corporation) 2 years after Sub 1 (Sub 2's former parent) was spun off, and BigCo B converts to a REIT 6 years later, BigCo B is subject to the Automatic Deemed Sale Rule, with the harsh results described above. We believe that a REIT conversion that occurs 8 years after a tax-free spin-off is unlikely to have occurred as part of a plan with the spin-off and, further, that if the conversion is not part of a plan with the spin-off, the transactions are unlikely to be used "to circumvent the Congressional policy implemented through section 311 of the PATH Act."[63]

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[60] *Cf.* 153 Cong. Rec. E385 (2007) (statement of Rep. Crowley) ("However, the 4-year requirement is arbitrary and not consistent with other Code provisions that define whether property is held for long term investments. . . . A 2-year holding period better reflects current economic realities.").

[61] *See, e.g.*, H.R. Conf. Rep. No. 105-220, at 528 (1997).

[62] Treas. Reg. § 1.707-3(c)(1).

[63] T.D. 9770 (2016).

On the other hand, a Conversion Transaction that occurs within two years of a tax-free spin-off is more likely to have occurred as part of a plan with the spin-off, and therefore more likely to be the sort of transaction with which the 2016 Regulations are concerned. We believe that our proposed 2-year presumption offers a reasonable compromise between the need for an easily administrable bright-line "blackout" period for the Automatic Deemed Sale Rule and the need to avoid subjecting to tax transactions that do not circumvent the Congressional policy underlying the PATH Act, and that our proposal is consistent with regulations governing analogous scenarios.[64]

We note that, although the PATH Act's prohibition on REIT elections following spin-offs is for 10 years, that 10-year period is not an appropriate analogy on which the Automatic Deemed Sale Rule should be based, most importantly because the scope of the Automatic Deemed sale rule, and its effect when it applies, are much broader than the scope and effect of the PATH Act provisions. In other words, it is especially important to narrowly tailor the application of the Automatic Deemed Sale Rule because the rule as currently drafted goes well beyond the Congressional policy underlying the PATH Act.

Specifically, the PATH Act's prohibition on REIT spin-offs denies tax-free treatment under section 355, while the 2016 Regulations impose harsher consequences. As discussed above, under the PATH Act, if a spin-off does not qualify for tax-free treatment, there are two primary consequences. First, the distributing corporation is generally required to recognize gain as if it had sold the stock of the controlled corporation to its shareholders. Second, the shareholders receiving the stock of the controlled corporation in the spin-off are generally treated as having received a taxable distribution equal to the fair market value of the controlled corporation's stock.[65]

Under the 2016 Regulations, however, if a C corporation were to spin off a subsidiary C corporation tax-free and then be acquired by a REIT, the distributing C corporation itself would be subject to the Automatic Deemed Sale Rule on its conversion to a REIT. The rule would subject the distributing corporation to tax on the built-in gain in *all* of its assets, not just on the stock of the subsidiary C corporation as required by the PATH Act. Additionally, if the acquiring REIT held any assets within that REIT's own recognition period, the acquisition of the distributing corporation apparently would also cause the acquiring REIT to be subject to the Automatic Deemed Sale Rule with respect to those assets. In other words, as drafted the 2016 Regulations go beyond their stated goal to prevent "circumvent[ion] of the Congressional policy implemented through section 311 of the PATH Act" (which simply requires REIT spin-offs to be taxable), by potentially imposing a far greater amount of tax on a far wider group of taxpayers than contemplated by the PATH Act.

Additionally, Congress precisely defined the scope of the PATH Act's prohibition on REIT spin-offs. While a C corporation generally may not participate in a tax-free REIT spin-off as either a

[64] *See* sections 355(e) and 707(a)(2)(B) and Treas. Reg. §§ 1.355-7 and 1.707-3.

[65] Section 301(c). Of course, following a taxable distribution, a spun-off C corporation is free to convert to a REIT.

distributing corporation or a controlled corporation under section 355, Congress decided to allow a REIT to spin-off a taxable REIT subsidiary—a C corporation by definition— provided that the REIT has been a REIT for at least three years prior to the spin-off. Similarly, Congress provided that the PATH Act's prohibition on tax-free spin-offs does not apply if the REIT-Only Spin-Off Exception applies, *i.e.*, if both the distributing corporation and controlled corporation are REITs immediately after the spin-off.

NAREIT believes that if Congress had intended to limit other spin-off transactions it would have done so explicitly. For example, nothing in the PATH Act prevents a C corporation from spinning off a subsidiary C corporation tax-free provided the requirements of section 355 are met and neither C corporation elects REIT status for 10 years. Under the 2016 Regulations, if any member of either corporation's SAG were to elect REIT status within the 20-year window described above, that affiliated corporation would be subject to the Automatic Deemed Sale Rule, despite being unconnected to the spin-off and completely outside the purview of the PATH Act. Similarly, the 2016 Regulations apply the Automatic Deemed Sale Rule to a spin-off otherwise treated as tax-free under the REIT-Only Spin-Off Exception if either the distributing corporation or controlled corporation ceases to be REIT within two years of the spin-off. The PATH Act does not prohibit such spin-offs, and nothing in the legislative history to the PATH Act indicates that Congress intended to limit section 355 in this manner. NAREIT believes that it is inappropriate for the 2016 Regulations to broaden the scope of the PATH Act in a manner that was not intended by Congress.

The 2016 Regulations' narrowing of the REIT-Only Spin-Off Exception is particularly troubling because it may effectively eliminate, rather than simply narrow, the REIT-Only Spin-Off Exception. Under the PATH Act, if a REIT spins-off a subsidiary that elects REIT status in connection with the spin, the distributing corporation can be confident that the spin-off will be tax-free if the requirements of section 355 are met. Under the 2016 Regulations, the tax treatment of the distributing corporation may be altered by actions taken up to two years later that may be completely outside the distributing corporation's control. For example, if the controlled corporation were to fail any of its REIT tests within two years of the spin-off transaction, both the controlled corporation and the distributing corporation would suffer adverse tax consequences under the Automatic Deemed Sale Rule. A REIT may be unwilling to spin-off a subsidiary REIT in light of this uncertainty, despite the fact that Congress clearly intended to provide an exception to the PATH Act for REIT spin-offs of other REITs.[66] Accordingly, NAREIT believes that the 2016 Regulations' narrowing of the REIT-Only Spin-Off Exception runs counter to Congressional intent.

[66] Additionally, we note that the application of the Automatic Deemed Sale Rule to the controlled corporation in this example seems inconsistent with the policy underlying section 1374 and *General Utilities* repeal more generally. Section 1374 is generally intended to prevent a corporation from escaping corporate-level tax by converting to an S corporation, RIC, or REIT and selling assets with built-in gain tax-free. In the example above, however, the controlled corporation *ceases* to be a REIT, meaning that assets are moving from a REIT to a C corporation. It is unclear why the Automatic Deemed Sale Rule would be required in such circumstances.

NAREIT also believes that it is important to limit the scope of the Automatic Deemed Sale Rule because the rule imposes significant economic costs in every future REIT acquisition transaction. First, the 2016 Regulations will require many acquiring corporations to conduct a prohibitive amount of diligence to ensure that a target corporation will not inadvertently cause the acquiror to be subject to the Automatic Deemed Sale Rule. Often, it will be impossible to reach a level of certainty sufficient to proceed with a transaction. For example, if a C corporation becomes a member of a REIT's SAG (whether by an acquisition or otherwise), the REIT risks being subject to the Automatic Deemed Sale Rule and thus being subject to tax on the built-in gain in all its assets within the recognition period unless it can be sure that the target C corporation did not participate in a tax-free spin-off within 10 years of the REIT's conversion and is also not a successor or predecessor to any corporation that participated in a tax-free spin-off.[67]

For example, under the 2016 Regulations, in order for a REIT to acquire a C corporation in a section 381 transaction without risking the imposition of the Automatic Deemed Sale Rule, the REIT must conclude that the following corporations were not, during the past 10 years, involved in a tax-free spin-off as either the distributing corporation or the controlled corporation: i) the target corporation; ii) any corporation acquired by the target corporation in a section 381 transaction (a target once removed); iii) any corporation acquired by the target once removed in a section 381 transaction; and, iv) any other corporation further along the section 381 acquisition chain. Given the volume of acquisitions in the C corporation space, this viral nature of the Automatic Deemed Sale Rule may, especially in the public company context, create an insurmountable tax due diligence problem.

Second, the 2016 Regulations create strong disincentives with respect to certain acquisitions. For example, a C corporation that holds real estate may avoid acquiring another C corporation if the target has recently engaged in a tax-free spin-off, because the acquiror will effectively be prevented from electing REIT status in the next 10 years.

Third, the potential costs of running afoul of the 2016 Regulations are disproportionate to the transactions that the 2016 Regulations are designed to limit. For example, if a $20 million C corporation converts to a REIT and immediately spins off a $5 million C corporation subsidiary, the built-in gain on the spin-off will be taxable immediately under the PATH Act. Assuming the $20 million C corporation has zero basis in the stock of the $5 million subsidiary, the maximum federal income tax imposed on the spin-off would likely be $2.4 million (calculated using a 35% corporate tax plus a 20% tax on the shareholders receiving stock of the subsidiary). However, instead of converting to a REIT, if the $20 million C corporation spun off its subsidiary and then merged (when it was worth $15 million) with a $1 billion REIT within the next 10 years, the $1 billion REIT would be required to recognize all of the built-in gain in its assets, to the extent that

[67] These diligence efforts would be further complicated because "predecessor" and "successor" are defined to "include" entities that have engaged in certain tax-free transactions, which leaves open the possibility that other transactions or situations may give rise to status as predecessors or successors. Thus, the successor and predecessor rules may be especially difficult to adequately diligence.

gain is subject to section 1374 treatment. As in the earlier example, this tax could be as much as $350 million.

This result—a tax nearly 150 times the tax that would have been imposed had the spin-off simply been taxable—seems particularly disproportionate in light of the PATH Act's purpose of preventing tax-free spin-off transactions involving REITs. Furthermore, NAREIT believes that this approach is inconsistent with the IRS' and Treasury Department's general approach with respect to the amount of gain recognized in connection with otherwise tax-free spin-offs under section 355.[68]

NAREIT's proposal would limit gain recognized under the Automatic Deemed Sale Rule to the built-in gain in assets that are both held by a corporation participating in the spin-off transaction and held by a corporation participating in the Conversion Transaction. Under this proposal, the gain recognized on the Conversion Transaction in the example above would be limited to $15 million—the built-in gain at the time of the spin-off in the assets that were both held by distributing corporation at the time of the spin-off (assuming the distributing corporation had zero basis in its assets) and held by the distributing corporation at the time of the Conversion Transaction. Such gain would further be reduced if and to the extent the controlled corporation had recognized such built-in gain in its assets prior to the Conversion Transaction. For example, if the controlled corporation had sold some of its assets to the converting corporation in a taxable transaction, the controlled corporation would not be required to recognize gain with respect to those assets a second time.

Absent these proposed limits, the possibility of viral and disproportionate results under the Automatic Deemed Sale Rule increases the relative cost of diligence. And in light of the broad scope and effect of the regulations in other respects—for example, their application to predecessors, successors, and members of SAGs, and the fact that they can trigger a deemed sale on assets that had no connection to the related spin-off—the 20-year "blackout" period, combined with the potential for tax costs far exceeding the tax that would have been imposed if the spin-off were simply taxable— will impose incredible, and we suspect unforeseen, diligence burdens on participants in regular, everyday merger and acquisition activity.

[68] *See* Prop. Treas. Reg. § 1.355-8(e), which provides rules limiting the amount of gain recognized under section 355(e) when there is an acquisition of 50% or more of the stock of the predecessor of the distributing corporation, but not of the distributing corporation itself. *See also* Notice of Proposed Rulemaking, Fed. Reg. Vol. 79, No. 11 (Jan 16, 2014) (noting that " if the excess of the gain inherent in the Controlled stock on the date of the distribution over the gain attributable to the assets of the predecessor is small relative to the full amount of gain inherent in the Controlled stock, it may seem inappropriate to require that Distributing recognize the full amount of gain inherent in the Controlled stock.")

Thank you again for the opportunity to submit these comments, and we request a public hearing at which we and perhaps others can discuss the issues raised in this letter. Feel free to contact me at tedwards@nareit.com, Catherine Barré, NAREIT's SVP for Policy & Politics, at cbarre@nareit.com, or Dara Bernstein, NAREIT's VP & Senior Tax Counsel, at dbernstein@nareit.com if you would like to discuss these issues in greater detail.

Respectfully submitted,

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