NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

July 7, 2016

VIA ELECTRONIC SUBMISSION [www.regulations.gov]

Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-108060-15)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Proposed Regulations: Treatment of Certain Interests in Corporations as Stock or Indebtedness (REG-108060-15)

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity to offer comments regarding the proposed regulations entitled "Treatment of Certain Interests in Corporations as Stock or Indebtedness" (REG-108060-15) (the Proposed Regulations).

NAREIT® 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. 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. 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.

EXECUTIVE SUMMARY

The Proposed Regulations provide for the partial or complete recharacterization of related party corporate (and, in some cases, partnership) debt as equity for federal income tax purposes under circumstances in which the debt has equity characteristics, the debt has not been contemporaneously substantiated, or the debt is issued in connection with certain distributions, reorganizations or other corporate transactions. The Proposed Regulations would

apply to corporations that issue debt to related corporations or partnerships.

In principle, providing guidance and clarity in distinguishing debt from equity could be a worthwhile exercise of regulatory authority, particularly because of the sharp differences in the tax treatment of debt and equity. However, NAREIT has strong concerns about the Proposed Regulations. These concerns range from the unusually short time frame that the Treasury Department and the Internal Revenue Service have allowed for public consideration and comment on such a major regulatory action to the uniquely harsh impact that the Proposed Regulations, as currently drafted, could have on REITs and their tax status.

First, the stated purpose of the Proposed Regulations is to address the "enhanced incentives" that related parties have to engage in transactions that reduce or eliminate their federal income tax liability through the use of "excessive indebtedness." However, the Proposed Regulations would have a much broader impact on REITs, despite the fact that REITs are required to distribute 90% of their taxable income to shareholders, and most REITs distribute 100%. As a result, the issues the Proposed Regulations purport to address are not present among REITs and their affiliates, and the "enhanced incentives" discussed in the Proposed Regulations do not exist.

Furthermore, the Proposed Regulations have potentially severe consequences for REITs beyond the loss of interest deductions for the issuer of the debt. Specifically, just as representatives of S corporations have raised issues regarding how application of the Proposed Regulations as currently drafted could result in revocation of their S corporation status, the reclassification of debt as equity under the Proposed Regulations could result in revocation of a company's REIT status either as a result of recharacterization of normal business transactions engaged in by the company or *de minimis* inadvertent actions by the company that are not tax-motivated.

For these reasons, and particularly because the "enhanced incentives" are not present for REITs, NAREIT requests that the Proposed Regulations be made inapplicable to debt held or issued by REITs or their subsidiaries. Alternatively, NAREIT requests that any recharacterization of debt as equity under the Proposed Regulations not apply for purposes of applying the various REIT qualification tests under subchapter M of the Internal Revenue Code of 1986.[1]

In addition, NAREIT requests that specific changes be made in the Proposed Regulations relating to the substantiation requirements, the so-called *Per Se* Funding Rule, as defined herein, and the effective dates. We believe that these changes should apply to all taxpayers. Many of these changes have been

[1] The Code. Unless otherwise provided, all references to a "section" herein shall be to the Code.

requested previously in comment letters submitted by others in response to the Proposed Regulations.[2] NAREIT agrees with these comments.

With regard to the substantiation requirements, more guidance is necessary to accommodate debt with various term features. Additionally, the information necessary to satisfy these requirements should not exceed the information a third party lender would require. Given the severity of the penalty that would apply to substantiation that is contemporaneously created by the lender but later asserted by the IRS to be inadequate, NAREIT requests that some accommodation (such as a "safe harbor" or an opportunity to amend or supplement the information) should be made for taxpayers that have made a good faith effort to satisfy the substantiation requirements.

With regard to the *Per Se* Funding Rule (as defined herein), NAREIT agrees with the comments of others that the rule should exclude so-called "cash pooling" and other similar treasury management functions, and is encouraged by recently reported remarks by Treasury Department officials that modifications to reflect these comments are under consideration.

In addition, the exception in the Proposed Regulations for acquisitions or distributions that do not exceed current year earnings and profits (E&P) should apply using the E&P of the prior year (or an average of prior years) since taxpayers cannot determine their current year E&P until after the end of the taxable year,[3] and the 72-month testing period should be considerably shortened, especially in the case of REITs and their subsidiaries which routinely make return of capital distributions. Further, the exception should include a safe harbor for distributions that exceed current year E&P by only some *de minimis* amount, *e.g.* 5%, or, alternatively, by an amount based on prior year (or prior years') E&P. In order to maintain REIT status, REITs are required by law to distribute almost all of their income. REITs often distribute in excess of this amount both to make certain that they satisfy this requirement and to meet market demand for yield.

The Proposed Regulations provide effective dates that can be applied retroactively to periods before the regulations are finalized. Such retroactive effective dates customarily have been used for regulating transactions that are inherently abusive. However, the Proposed Regulations could apply to commercially reasonable transactions that are not inherently abusive or even tax-motivated. Therefore, the Proposed Regulations should apply only to debt issued after the date on which they become final to avoid becoming a trap for the unwary.

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[2] *See*, *e.g.*, DC Bar Tax Section Comment Letter on Proposed Section 385 Regulations (June 29, 2016) and U.S. Chamber of Commerce Comment Letter on Proposed Section 385 Regulations (July 6, 2016).

[3] REITs in particular cannot determine current year E&P until well past the end of the taxable year after REIT taxable income has been computed.

Finally, the Proposed Regulations would alter a longstanding and well-established body of tax law in significant ways, with unforeseeable changes to how this body of tax law is applied in practice by taxpayers and the IRS alike. Therefore, these comments by necessity do not (and cannot) represent a full discussion of all of the issues raised by the Proposed Regulations as they may apply to REITs. NAREIT believes that thoughtful consideration of the Proposed Regulations requires a longer comment period that is appropriate and commensurate with the enormity of these modifications and their potential consequences to taxpayers in general, and REITs in particular.

DISCUSSION

A. Background: Overview of the Proposed Regulations

Although issuance of the Proposed Regulations evidently was influenced by recent foreign acquisitions (or proposed or announced acquisitions) of U.S. companies (colloquially known as "inversions") and associated concerns about earnings stripping, the Proposed Regulations have three separate substantive sections that would make considerable changes to the characterization of financing arrangements as either debt or equity, at least with regard to financing arrangements between related (but not consolidated) corporations. Although the Proposed Regulations have been issued primarily under the authority of section 385—which applies to "an interest in a corporation"—the Proposed Regulations would apply to debt issued by both corporations and partnerships that are controlled by corporations (with controlled partnerships treated as aggregates of their corporate partners rather than as separate entities for purposes of the Proposed Regulations).

Prop. Treas. Reg. § 1.385-1 defines the terms that are used in the Proposed Regulations, and also authorizes the IRS to bifurcate financing arrangements into partial debt and partial equity, although the Proposed Regulations provide no guidance as to how the IRS should or would exercise this authority.

Prop. Treas. Reg. § 1.385-2 precludes the treatment of a financing arrangement as debt for federal income tax purposes if the issuer does not create and maintain substantiation or documentation that provides: 1) a legally binding obligation to pay; 2) creditor's rights to enforce the obligation; 3) a reasonable expectation of repayment at the time the interest is created; and, 4) an ongoing relationship during the life of the interest that is consistent with arm's-length relationships between unrelated debtors and creditors (the Substantiation Rule). The Substantiation Rule would convert what currently is an evidentiary requirement to determine the intent of the parties into a binding prerequisite for debt treatment that, in some cases, could actually override the intent of the parties to enter into a

creditor relationship.

Prop. Treas. Reg. § 1.385-3 would recharacterize debt as equity when the debt is issued between affiliated entities in connection with certain distributions of debt instruments. Debt also would be recharacterized as equity if the debt is issued with a principal purpose of funding certain distributions or acquisitions, and debt would be *per se* treated as issued with such a principal purpose if the debt is issued within 36 months before or after the date of certain distributions or acquisitions (the *Per Se* Funding Rule). However, debt would not be treated as issued with such a principal purpose to the extent the distributions or acquisitions do not exceed current year E&P.

Prop. Treas. Reg. § 1.385-4 would apply to the treatment of consolidated groups. Because REITs generally cannot be included in consolidated groups, those provisions will not be discussed herein.

While Prop. Treas. Reg. §§ 1.385-1 and 1.385-2 generally would apply to debt instruments issued after the date that final regulations are issued, Prop. Treas. Reg. § 1.385-3 generally would apply to debt instruments issued on or after April 4, 2016.

B. Background: REITs

1. REITs Generally

Authorized by Congress over 50 years ago, and based on the model for mutual funds, REITs are vehicles through which investors can invest in professionally-managed portfolios of real estate assets to obtain the diversification and performance benefits of real estate investment ordinarily only accessible to institutions and wealthy investors.[4] Stock in publicly traded REITs typically is held by retail investors, either directly or indirectly through mutual funds. Investing in a diverse, professionally managed portfolio of real estate assets provides all Americans access to, and the benefits of investing in, large scale income-producing real estate, without the risks and transaction costs associated with investing in individual properties.

Like a mutual fund, a REIT is entitled to a deduction from entity-level taxable income for distributions of taxable income to shareholders that qualify as dividends each year. These dividends generally are taxed in the hands of each shareholder at the highest marginal rate applicable to that shareholder's ordinary income, not at the lower "qualified dividend" rate. However, to achieve this tax treatment, sections 856 through 860 require a REIT to satisfy several tests, including those related to the nature of the REIT's assets, the sources of its gross

[4] H.R. Rep. No. 2020, 86th Cong., 2d Sess. 3 (1960).

income, its mandatory distributions to its shareholders, and the ownership of its stock. Although REIT taxable income in general is not subject to a corporate-level tax to the extent that it is distributed to shareholders, the REIT gross income and asset tests, coupled with the mandatory distribution rules and the fact that REITs may not pass through losses and credits to investors, distinguish REITs from partnerships and other types of fiscally transparent entities.

The Proposed Regulations were motivated to a great extent by inversion transactions. It is notable that a REIT cannot invert since a foreign corporation, trust or association may not qualify as a REIT.[5]

2. REIT Gross Income and Asset Tests and the 90% Distribution Requirement

a. *Gross Income Tests*

To ensure that a REIT derives substantially all of its income from real estate related sources, a REIT is required to derive at least 75% of its gross income each year from, *inter alia*: 1) rents from real property; 2) interest on obligations secured by mortgages on real property or on interests in real property; and, 3) gain from the sale or other disposition of real property, including interests in real property and interest in mortgages on real property, that is not "dealer property" (*i.e.*, property held primarily for sale to customers in the ordinary course of business)[6] (the 75% Gross Income Test). A REIT also is required to derive at least 95% of its gross income each year from any income that is qualifying for the 75% Gross Income Test, interest, dividends, and gains from the sale or other disposition of stock, securities and real estate that is not "dealer property"[7] (95% Gross Income Test).

b. *Asset Tests*

To ensure that a REIT principally invests in real property, several asset tests exist for REITs. Among other requirements, on a quarterly basis, 1) at least 75% of the value of a REIT's total assets must be from "real estate" sources (the 75% Asset Test)[8]; 2) a REIT cannot own more than 10% of the vote or value in a corporation other than another REIT, a "taxable REIT subsidiary" (TRS) or a wholly owned "qualified REIT subsidiary" (QRS)[9] (the 10% Asset Test); and, 3) the value of the securities of all TRSs cannot exceed more than 25% (20% starting in 2018 under

[5] Rev. Rul. 89-130, 89-2 C.B. 117.
[6] Section 856(c)(3).
[7] Section 856(c)(2).
[8] Section 856(c)(4).
[9] Under section 856(i), a QRS is treated as a disregarded entity of its parent REIT.

the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act)[10] passed last December) of a REIT's assets (the TRS Asset Test).[11] A TRS is a fully taxable corporate subsidiary of a REIT. A REIT and affiliated TRSs must elect jointly for the TRS or TRSs to be treated as TRSs. A REIT is viewed as owning its proportionate interest in a partnership's income and assets (the Partnership Look-Through Rule).[12]

c. *100% Excise Tax on Non-Arm's Length Transactions between a REIT and its TRS*

In enacting the legislation in 1999 that created TRSs, Congress adopted a rather draconian approach (beyond the generally applicable transfer pricing rules under section 482) to ensure that transactions between a REIT and its TRS (as well as transactions between a TRS and the controlling REIT's tenants) are comparable to those between unrelated parties. Specifically, Congress imposed a 100% excise tax on income generated by non-arm's length transactions between such parties.

By virtue of this 100% excise tax, a REIT or TRS forfeits all of its profits if the terms of its rents, deductions or interest rates on loans between the REIT and the TRS or the TRS and the REIT's tenants are not at arm's length.[13] The PATH Act enacted last December extended the 100% excise tax to the underpricing of services such as construction services that a TRS renders to its controlling REIT. In determining arm's length interest on loans by a REIT to its TRS, the Code adopts the earnings stripping rules under section 163(j).[14]

d. *Distribution Test*

Generally, a REIT must distribute 90% of its "REIT taxable income" (excluding net capital gain) each year (the 90% Distribution Requirement).[15] Like a mutual fund, a REIT is allowed a dividends paid deduction in computing its taxable income.[16] Thus, to the extent a REIT distributes 100% of its taxable income, it will not pay corporate income tax. Most REITs distribute at least 100% of their taxable income. As with mutual funds, the tax burden from a REIT's activities is borne by the REIT's shareholders. Public listed REITs paid out approximately $46.5 billion and public non-listed REITs paid out approximately $4.5 billion in dividends during 2015, most of which were taxed at the ordinary income rate, not the lower rate applicable to qualified corporate dividends. Over 200 U.S. REITs

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[10] Enacted as part of Pub. Law 114-113, the "Consolidated Appropriations Act, 2016."
[11] Section 856(c)(4)(B)(ii).
[12] Treas. Reg. § 1.856-3(g).
[13] Section 857(b)(7)(A).
[14] Section 163(j)(3)(C).
[15] Section 857(a)(1)(A). A limited exception from the 90% Distribution Requirement is available for certain types of "phantom" or "noncash" income recognized by a REIT. Section 857(a)(1)(B).
[16] Section 857(b)(2)(B).

are currently listed on stock exchanges, and they currently have an equity market capitalization of almost $1 trillion.[17]

Ultimately, if a REIT fails to satisfy the 90% Distribution Requirement, the REIT will lose its REIT status. This would cause the REIT to be treated as a C corporation that is subject to regular corporate income tax for the year of the failure and for the following four years**,** unless the REIT obtains the consent of the IRS to maintain or regain its REIT status.[18] The corporate income tax resulting from a failure to satisfy the 90% Distribution Requirement would greatly reduce the distributions the REIT could pay its shareholders and likely would significantly reduce the value of the REIT's stock.

e. *Preferential Dividend Rule*

Prior to the PATH Act, all REITs were subject to what is known as the "preferential dividend" rule. A distribution by any REIT was not considered as a "dividend" for purposes of computing the dividends paid deduction if it was treated as a "preferential dividend" under section 562(c). The failure of a REIT distribution to be considered as a "dividend" for purposes of computing the dividends paid deduction could cause the REIT to lose its status as such.

The PATH Act repealed the preferential dividend rule for publicly offered REITs, which are defined as REITs that are required to file annual and periodic reports with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934. For other REITs, the PATH Act added section 562(e)(2), which provides the government with the authority to prescribe guidance in this area for other REITs.

C. Issues under the Proposed Regulations

1. General Issues

a. *Substantiation Rule*

The substantiation requirements of the Proposed Regulations create significant uncertainty for typical business arrangements such as hedging of debt obligations, cash pooling and other similar treasury management functions. This uncertainty is further amplified for non-recourse debt because these requirements appear to assume that all debt is recourse debt.

[17] *REITWatch*® (May 2016) (NAREIT), available at:
https://www.reit.com/sites/default/files/reitwatch/RW1605.pdf .
[18] Section 856(g)(3) (prohibiting an entity that has failed to qualify as a REIT from electing REIT status for the next four taxable years).

Similar issues in complying with the Substantiation Rule are likely to arise with other types of debt which have commercially available terms that vary from conventional fixed-term, fixed-rate debt. Therefore, NAREIT recommends that the Proposed Regulations provide more guidance to taxpayers and the IRS with regard to the information that is required to satisfy the Substantiation Rule, particularly as it relates to non-recourse debt, and that the Proposed Regulations do not require more information than would be required by a third party lender.

Finally, situations could arise when taxpayers have attempted to comply with the Substantiation Rule and, in fact, believe in good faith that they have complied—but the IRS may later assert on audit that the information maintained in complying with the Substantiation Rule is incomplete or lacks sufficient detail. Even in this situation, the consequence of this assertion would be complete recharacterization of the debt as equity (even if it is clear that the debt is valid debt). Because of the potential for this outcome, the Substantiation Rule should provide some relief for taxpayers that have made a good faith effort to satisfy the substantiation requirements (such as a "safe harbor" or an opportunity to amend or supplement the information when appropriate).

b. *Per Se Funding Rule*

The exception from the *Per Se* Funding Rule for current year E&P provides a measure of relief from what is otherwise an arbitrary (and overly broad) 6-year period within which the issuance of debt is recharacterized as the issuance of equity if there also are one or more instances of certain distributions or acquisitions. However, current year E&P cannot be determined until many months after the end of the year (by definition after the distribution or acquisition in question), or even later if there are subsequent audit adjustments or other non-tax–related revisions.[19]

For example, retail landlords often have leases with percentage rents based on their tenants' gross sales from the important end-of-year shopping season. The landlord must wait for the tenants to compile their year-end sales results and then further communicate these results to the landlord before it knows its current year E&P. Further, a real estate investor may be a minority partner in a joint venture and may not receive the results of that investment until it receives a K-1 several months following the end of a taxable year.

The delays and uncertainties around the calculation of current year E&P, as well as market demands for yield, have caused listed REITs to err on the side of over-distribution, thereby creating a consistent pattern of a portion of listed REITs' distributions representing a return of capital.[20]

[19] Note that company annual reports on SEC Forms 10-K are not filed until 60 days after year-end.
[20] *See* https://www.reit.com/sites/default/files/1099/HistoricalDividendAllocationSummary.pdf.

Therefore, NAREIT recommends that:1) the exception should apply using a safe harbor equal to the greater of: a) the current year's E&P,[21] or b) the prior year's E&P (or perhaps some multi-year E&P average to smooth out year-to-year fluctuations in E&P); 2) the exception should apply if distributions or acquisitions exceed current year E&P only by an appropriate *de minimis* amount, *e.g.*, 5%, to parallel the 95% Gross Income Test; and, 3) the 72-month testing period be substantially shortened, *e.g.*, to 36 months.[22]

c. *Effective Date*

The Proposed Regulations—Prop. Treas. Reg. § 1.385-3, in particular—generally would apply to debt instruments issued after April 4, 2016, the date of issuance of the Proposed Regulations. The use of an effective date that is based on the issuance of proposed regulations (as opposed to the issuance date of final regulations) traditionally has been reserved for transactions that are well-defined and inherently abusive.

In attempting to identify debt-funded acquisitions and distributions, Prop. Treas. Reg. § 1.385-3 deals with the fungibility of money through the *Per Se* Funding Rule, which establishes a non-rebuttable presumption that an acquisition or distribution has been funded with debt if the debt is issued within 3 years before or after the acquisition or distribution takes place. This presumption leaves no room to excuse situations when the debt issuance is, in fact, completely unrelated to the acquisition or distribution (including situations described below involving REITs). Accordingly, it can be expected that the *Per Se* Funding Rule by definition would apply to commercial transactions that are not tax-motivated.

Moreover, the complexity of Prop. Treas. Reg. § 1.385-3 and the transactions to which it would apply suggest that further modifications or refinements to the Proposed Regulations will be made as comments are reviewed and the regulatory process moves forward. This means that the specific transactions and facts to which Prop. Treas. Reg. § 1.385-3 ultimately will apply if and when the Proposed Regulations become final are not yet well-defined. This will create (and already has created) substantial uncertainty over the status of debt issued since April 4,

[21] We recommend that this safe harbor be based on a "best efforts" calculation of E&P in order to achieve certainty regarding the application of the safe harbor. There are situations in which E&P can be under audit the ultimate resolution of which may not be clear at the time the safe harbor calculation is made. Greater certainty would be available if companies could rely on a "best efforts" determination of E&P.
[22] As noted above, NAREIT has recommended that the Proposed Regulations not apply to debt issued by REITs and their subsidiaries. Because of the need for a REIT and its affiliates to fund the 90% Distribution Requirement out of currently available cash, there is a greater risk that REITs (as opposed to non-REITs) inadvertently – and, as a result, of ordinary business transactions - may trigger the *Per Se* Funding Rule.

2016 and planning for transactions that could occur prior to finalization of the Proposed Regulations, including transactions that would be done for non-tax commercial reasons.

Because the *Per Se* Funding Rule would apply to transactions that are not inherently abusive and not yet well-defined, the effective date for Prop. Treas. Reg. § 1.385-3 should be prospective from the date the Proposed Regulations are made final.

2. REIT-Specific Issues

In most (but not all) cases, the principal consequence to taxpayers of recharacterizating debt as equity under the Proposed Regulations is the loss of interest deductions and the imposition of dividend withholding taxes. With regard to REITs, however, the Proposed Regulations could actually jeopardize a REIT's status as a REIT in several ways. This result may occur because several REIT qualification tests contain equity ownership requirements or limitations that could be affected by the Proposed Regulations. In addition, recasting debt as equity under the Proposed Regulations could affect a REIT's compliance with the REIT qualification income tests by converting interest income on debt that is principally secured by real estate into other forms of income. These problems are exacerbated by the prevalence of complex partnership structures and the treatment of partnerships under the Proposed Regulations.

Because the recharacterization of debt as equity under the Proposed Regulations is most likely to occur on audit, REITs will have no opportunity to cure these issues. Consequently, the adverse impact of the Proposed Regulations on REITs could extend far beyond the denial of interest deductions.

a. *General REIT Qualification Issues*

The Proposed Regulations could cause problems under REIT requirements and rules, such as the TRS Asset Test, the 75% Asset Test or the 75% Gross Income Test if a debt obligation secured by an interest in real property is recharacterized as equity. For example, the application of the Proposed Regulations to this situation is particularly unnecessary because REITs already are subject to the 100% excess interest excise tax, and TRSs are subject to section 163(j)(3)(C), both of which operate to prevent earnings stripping out of a TRS.

For example, a REIT does not directly develop and sell condominiums because condominium sales represent prohibited transactions under section 857(b)(6) and therefore a REIT's gains therefrom would be forfeited to the IRS through the 100% excise tax imposed on such "dealer sales." Therefore, a REIT typically would use its TRS to develop and sell condominiums, and since a listed REIT has

a lower cost of capital[23] than its TRS, the REIT often loans funds to its TRS with the land and buildings owned by the TRS securing the loan. As with third party lending for condominium development and sales, the terms of the REIT loan to its TRS typically call for the TRS to pay off the loan as condominium sales close.

This condominium loan example could present multiple causes for REIT status failure under the Proposed Regulations. First, a REIT's loan to its TRS that is secured by real estate is considered a real estate loan rather than TRS "securities."[24] A REIT that is close to exceeding the TRS Asset Test would violate this limit and lose its REIT status if its real estate loans to the TRS were recharacterized as equity. Second, the debt obligation—by virtue of being secured by an interest in real property—itself is an interest in real property that satisfies the 75% Asset Test, and the interest income from the debt obligation satisfies the 75% Gross Income Test. If recast as equity, the security would no longer satisfy the 75% Asset Test and the income therefrom would not satisfy the 75% Gross Income Test (although it would satisfy the 95% Income Test). Thus, a REIT that is close to either 75% test might risk its REIT status in multiple ways simply because of the recharacterization of the loan under the Proposed Regulations.

Another example involves a situation in which a listed REIT owns stock in a subsidiary REIT. This ownership may exist for several reasons, such as keeping an acquired REIT alive so to avoid triggering property tax revaluations at the state level or to avoid acceleration of debt covenants.[25] The ownership by listed REITs of subsidiary REITs was contemplated and acknowledged as an acceptable structure by the PATH Act in the FIRPTA context.[26] In these cases, the listed REIT may lend to the subsidiary REIT because of the former's lower cost of capital.

If the Proposed Regulations were to treat the loan as equity, then the payments from the subsidiary REIT would be recharacterized as dividends which would then need to be tested under the preferential dividend rules.[27] If the payments on the loan were treated as preferential dividends, the subsidiary REIT might not meet its 90% Distribution Requirement and therefore could lose its REIT status. If this were to occur, the listed REIT's investment in the subsidiary REIT no longer would be considered a qualifying REIT asset[28] that produces qualifying income

[23] More than two-third of listed equity REITs have investment grade ratings.
[24] *See, e.g.*, PLRs 201537020 (Sept. 11, 2015), 201503010 (Jan. 16, 2015), and 201431020 (Aug. 1, 2015).
[25] The IRS has issued several private letter rulings involving subsidiary REITs. *See*, *e.g.*, PLRs 201614009 (Jan. 4, 2016), 201341032 (Apr. 15, 2013), and 200821020 (Feb. 22, 2008).
[26] Section 897(h)(4)(E)(ii).
[27] There are numerous examples of inadvertent and *de minimis* distributions that can lead to loss of REIT status. In a letter dated May 16, 2016, NAREIT asked the government to issue guidance to address some of the more common cases that should not produce this result.
[28] Section 856(c)(5)(B) provides that shares in other REITs are considered real estate assets.

under the 75% Gross Income Test.[29] This result could cause the listed REIT to lose its status as a REIT as well. Obviously, this cascading effect would have a devastating impact on the listed REIT's shareholders.

Yet another example involves a QRS. By law, a REIT must own 100% of the stock of the QRS.[30] However, a related party (such as a TRS or REIT-owned partnership) may extend loans to the QRS. If such loans are recharacterized as equity, the REIT would fail to own 100% of the QRS, and the REIT would be viewed as owning more than 10% of a corporation that is not a TRS or REIT. Thus, the REIT would fail the 10% Asset Test.[31]

Moreover, REITs regularly enter into hedging transactions in order to manage interest rate (or even currency) risk, and any income from these hedging transactions is not taken into account for purposes of either the 75% Gross Income Test or the 95% Gross Income Test. Recharacterizing hedged debt as equity under the Proposed Regulations could result in hedging income being taken into account for purposes of these tests, and the income would not represent qualifying income.

b. *Partnership Issues*

In general, REITs that own interests in partnerships and that hold debt issued by the partnerships could fail to satisfy the 10% Asset Test if the debt is recast as equity under the Proposed Regulations. This result could occur because the REIT's proportionate share of the partnership assets—which could include ownership of another entity—could exceed 10% under the Partnership Look-Through Rule following the recharacterization of the partnership debt into equity.

REITs and their TRSs commonly use partnerships to invest in real estate developments, and these investments could be affected by the Proposed Regulations in several ways. For example, when a TRS holds a controlling interest in a partnership that is engaged in real estate development, and the parent REIT makes a mortgage loan to the partnership, issues could arise under the Proposed Regulations—and, in particular, the *Per Se* Funding Rule, if the TRS makes a distribution to the REIT that is unrelated to the real estate development but occurs within the 72-month window of the *Per Se* Funding Rule. As noted earlier, the partnership is treated as an aggregate of the TRS and any other

[29] Section 856(c)(3)((D) provides that dividends from, or gain from the sale of stock in, another REIT is qualifying income under the 75% Gross Income Test.
[30] Section 856(i)(2).
[31] NAREIT notes that the D.C. Bar's comments on the Proposed Regulations recommended that: "related-party debt instruments treated as stock under the Proposed Regulations not be treated as "stock" for purposes of disqualifying a corporation from one of the Code's alternative corporate tax regimes, including qualifying as an S Corporation or a REIT."

corporate partners, and, therefore, the TRS—rather than the partnership— would be treated as having issued the debt to the REIT.

In practice, the treatment of partnerships under the Proposed Regulations likely would create significant uncertainty and unpredictable consequences because even determining when and whether a partnership is subject to the Proposed Regulations could be affected by special allocations and preferred partnership returns—common features of real estate investment and development—as well as the entry and withdrawal of partners. For example, the mortgage loan discussed above could have been issued by the partnership to the parent REIT before the TRS secured a controlling interest in the partnership, yet a later unrelated distribution by the TRS to the REIT after the TRS secured control of the partnership could cause the mortgage loan to be recast as equity under the *Per Se* Funding Rule.

D. Conclusion

With the benefit of more time to review the Proposed Regulations, NAREIT believes that additional issues will emerge from the application of the Proposed Regulations to REITs. For this reason, NAREIT joins others[32] in requesting that the comment period be extended and the effective date delayed so that these additional issues can be more fully identified and, along with the issues described above, receive due consideration.

However, based on the issues and problems already identified and discussed above, and particularly because of existing rules limiting the amount of debt issued by REITs and their affiliates, NAREIT requests that the Proposed Regulations be made inapplicable to debt held or issued by REITs or their subsidiaries. At the very least, we request that the Proposed Regulations be made inapplicable for purposes of applying the REIT qualification tests under subchapter M.

[32] *See, e.g.,* Letter from the U.S. Chamber of Commerce regarding the Proposed Section 385 Regulations (May 6, 2016) and Letter from the Associated General Contractors of America regarding Notice of Proposed Rulemaking (June 28, 2016).

We would be pleased to 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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