

Concurrent Session: Implementing PATH Act Tax Changes

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La Quinta Resort & Club, La Quinta, California

Moderator:

Mark Van Deusen, Principal, Deloitte LLP

Panelists:

A. Cristina Arumi, Partner, EY

Stephen Giordano, Principal, KMPG LLP

Adam Handler, Principal, PwC

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REIT

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Implementing PATH Act Tax
Changes



Presenters

Christina Arumi
Principal - Washington National Tax
Ernst & Young LLC

Adam Handler
Principal - National Tax Services
PricewaterhouseCoopers LLP

Stephen J. Giordano
Principal - Washington National Tax
KPMG LLP

Mark Van Deusen
Principal - Washington National Tax
Deloitte Tax LLP

Agenda

- 1) Preferential Dividend Rule
- 2) REIT Spin-Offs
- 3) FIRPTA
- 4) U.S REIT Act

Preferential Dividend Rule

Preferential Dividends, Pre-PATH Act

- ◆ Fear of foot-faults resulting in current or potential REIT-qualification problems (REIT qualification, undistributed income)
- ◆ Confusion as to whether certain actual or deemed distributions were tainted
- ◆ Solving the problem without a closing agreement generally required a deficiency dividend or use of the “reasonable cause” provisions of Section 856(g)(5)

PATH Act – Publicly Offered REITs

- ◆ New Section 562(c)(1) – “publicly offered REITs” no longer denied a deduction on preferential dividends
 - ◆ “Publicly offered REIT” – a REIT required to file annual reports with the SEC under the Securities Exchange Act of 1934 (Section 562(c)(2))
 - ◆ Includes REITs traded on US exchanges and well as “public, non-listed REITs”
 - ◆ May not include REITs traded on foreign exchanges, such as in Canada

PATH Act – “Private” REITs

- ◆ New Section 562(e)(2)

In the case of a failure of a distribution by a REIT to comply with the requirements of subsection (c) [i.e., the preferential-dividend provision], *the Secretary may provide* an appropriate remedy to cure such failure in lieu of not considering the distribution to be a dividend for purposes of computing the dividends paid deduction if:

emphasis added

PATH Act – “Private” REITs (cont’d)

- (A) *the Secretary determines* that such failure is inadvertent or is due to reasonable cause and not due to willful neglect, or

- (A) such failure is of a type of failure *which the Secretary has identified* for purposes of this paragraph as being described in subparagraph (A).

emphasis added

NAREIT Comments

- ◆ May 16, 2016
- ◆ Consider treating REITs that are subsidiaries of “publicly offered REITs” (i.e., REITs included in the consolidated GAAP financial statements, filed with the SEC, of a parent REIT) as being exempt from the preferential dividend rule

NAREIT Comments (cont'd)

- ◆ Issue a revenue procedure where the IRS uses its authority under Section 562(e)(1) to:
 - ◆ List certain *de minimis* violations with respect to which REITs will not be treated as having paid a preferential dividend
 - ◆ Permit REITs otherwise to remedy a preferential dividends violation by self-assessing a penalty (rather than by paying a deficiency dividend) where the problem is either (A) inadvertent or (B) due to reasonable cause and not willful neglect

State of Play

- ◆ For most Public REITs, then, the preferential dividend issue is now off the table (but see: the fast-pay rules and other possibilities for recharacterization)
- ◆ Private REITs (and some foreign-traded Public REITs)
 - ◆ There has been no guidance from the IRS as to how it would exercise its authority under Section 562(e)(2)
 - ◆ Absent IRS guidance, it seems that nothing has changed *for REITs other than publicly-offered REITs*
 - ◆ Significant questions remain for certain structures

Remaining Issues

- ◆ Absent IRS guidance, practitioners may look to either the potential availability of deficiency dividend procedures or the reasonable cause provisions of Section 856(g)(5)
 - ◆ Deficiency dividends require cash or consent dividends, may duplicate shareholder income, and present E&P complexities
 - ◆ Section 856(g)(5) appears to require the payment of penalty to be effective, and may not apply to the REIT's initial election-year
 - ◆ Neither technique is sure to be available after a REIT has liquidated, depending on the specific type of transaction

Remaining Issues (cont'd)

- ◆ Divergent sharing of certain expenses, including and management fees in REIT-fund structures
 - ◆ PLR 201444022 – the IRS ruled that a “Class A/B structure,” where economics associated with a REIT’s classes of stock reflected different sharing of the burden associated with management fees would result in preferential dividends
 - ◆ IRS disregarded the separate, formal rights of the classes
 - ◆ Not clear that the IRS’s view is correct

Remaining Issues (cont'd)

- ◆ Similar concerns sometimes arise in partnership-over-REIT structures where partners share burden of management fees (or certain other REIT expenses) differently
 - ◆ The level of concern generally depends on the facts associated with the structure, and specifically the risk of the partnership being disregarded (under the partnership anti-abuse regulations or otherwise)

Opinions & Preferential Dividends (cont'd)

- ◆ In many cases, advisers may be able to issue a will-level REIT-qualification opinion even where they cannot reach a will-level of comfort on each point necessary to REIT qualification, relying on the assumed availability of savings provisions
- ◆ As mentioned above, though, those savings provisions that, absent new guidance from the IRS under Section 562(e)(2), are most appropriate to solving preferential-dividend problems require some future action – either a deficiency dividend or the payment of a penalty (under Section 856(g)(5))

Opinions & Preferential Dividends (cont'd)

- ◆ Query whether reliance on the savings provisions to reach an overall will-level of comfort will always be reasonable where there preferential dividends concerns – particularly when the REIT is being sold and it is known that the buyer intends to liquidate the REIT
 - ◆ Some of these concerns might still remain if the draft revenue procedure is implemented – if the payment of the penalty is a condition to curing the *non-de minimis* failure to comply with the preferential dividend rule

Opinions & Preferential Dividends (cont'd)

- ◆ A REIT-qualification opinion can fulfill several purposes:
 - ◆ Forces the REIT's advisers, who have superior information, in some sense to stand behind the REIT
 - ◆ Reflects a good faith investigation, potentially making the buyer more sympathetic in instances where a problem subsequently is discovered
 - ◆ In theory at least, may be a potential source of recovery of damages

Opinions & Preferential Dividends (cont'd)

- ◆ And so, what is the value of a will-level opinion in these circumstances?
 - ◆ Where the buyer's advisers are aware of the REIT-qualification issue, and are not themselves at a will-level of comfort, what additional comfort does a will-level of comfort provide?

Opinions & Preferential Dividends (cont'd)

- ◆ Is a something other than a “clean” will-level opinion sufficient?
 - ◆ “Reasoned” should
 - ◆ Will with a should-level carveout
 - ◆ Will with qualifications

REIT Spin-offs

Spin-Offs: General Rules

- ◆ New section 355(h): spin-off in which the distributing corporation (D) or the controlled corporation (C) is a REIT do not qualify for tax-deferred treatment under section 355.
- ◆ New section 856(c)(8): no corporation that was a D or a C in a section 355 transaction may elect REIT status for 10 years following the distribution.

PATH Act Spin-Off Exceptions

- ◆ TRS Exception. A spin-off of a taxable REIT subsidiary (TRS) by a REIT can qualify for tax-deferred treatment under section 355 so long as
 - ◆ The REIT has qualified as a REIT at all times during the 3-year period before the distribution,
 - ◆ C had been a TRS of the REIT at all times during that 3-year period, and
 - ◆ The REIT had “control” (under section 368(c)) of the TRS at all times during that 3-year period.
- ◆ Note that the general 5-year active trade or business (ATB) requirement in section 355(b) still applies to a TRS-on-REIT spin-off.

PATH Act Spin-Off Exceptions

- ◆ REIT-on-REIT Spin-Offs. A spin-off can qualify under section 355 so long as both C and D are, immediately after the distribution, REITs.
 - ◆ C or D will be treated as a REIT immediately after the distribution as a result of a REIT election made after the spin-off that is effective immediately after the distribution. See Treas. Reg. 1.337(d)-7T(f)(3)(i); *Bluebook* at 264, footnote 896.

REIT-on-REIT Spin-Offs

- ◆ A REIT-on-REIT spin-off still must satisfy the requirements of section 355, including the ATB requirement.
- ◆ Rev. Rul. 2001-29: the provision of customary services under a lease producing “rents from real property” may be treated as an active trade or business.
- ◆ Most, if not all, REITs involved in tax-deferred spin-offs have not relied on Rev. Rul. 2001-29 to satisfy the ATB requirement.

REIT-on-REIT Spin-Offs

- ◆ End of the “Hot Dog Stand” Spin-Off?
 - ◆ Prop. Treas. Reg. § 1.355-9:
 - ◆ At least 5% of the value of C and D must have been active business assets during the 5-year period to satisfy the ATB requirement.
 - ◆ Prop. Treas. Reg. § 1.355-2:
 - ◆ Even if 5% threshold is satisfied, significant non-business assets can be evidence of a “device.”

REIT-on-REIT Spin-Offs

- ◆ Independent Contractors.

- ◆ Treas. Reg. § 1.335-3(b)(2)(iii): activities conducted by persons outside of the corporation, including independent contractors, generally do *not* count for the ATB requirement.
 - ◆ Externally advised REITs
 - ◆ Hotel and health care REITs in RIDEA structures

Taxable REIT-on-REIT Spin-Offs

- ◆ PATH Act did not change the rules for taxable REIT spin-offs.
- ◆ A taxable REIT-on-REIT spin-off is significantly more tax efficient than a taxable spin-off by a C corporation.
 - ◆ D REIT will recognize gain (but not loss) on the distribution of the stock the C REIT. I.R.C. § 311(b).
 - ◆ If there is a significant loss in the assets of C, consider using intercompany sales before the spin-off to trigger losses that would be recognized at the time of the spin-off. See PLR 201705004 (Feb. 2, 2017).

Taxable REIT-on-REIT Spin-Offs

- ◆ D REIT will receive a dividends paid deduction in an amount equal to the value of stock of the C REIT distributed to shareholders.
 - ◆ Dividends paid deduction from the spin-off stock should offset any gain at the REIT level.
- ◆ D REIT shareholders will have additional dividend income attributable to the earning and profits recognized by D REIT on the spin-off
 - ◆ A significant portion of the additional dividend income should be eligible to be a designated as a capital gain dividend.
 - ◆ End Result: Transaction will generally involve tax only at the shareholder level.

Taxable REIT-on-REIT Spin-Offs

- ◆ Section 336(e) Election/Basis Step-Up. C REIT with built-in gain may receive a step-up in basis in its assets if a section 336(e) election is made. Treas. Reg. § 1.336-2.
- ◆ A section 336(e) election would cause a C REIT to be treated as selling all of its assets to a new corporation at fair market value in a taxable transaction and liquidating. D REIT would be treated as acquiring the stock of the new corporation for the cash and then distributing the stock of the new corporation.

Taxable REIT-on-REIT Spin-Offs

- ◆ Among other requirements for a section 336(e) election, D REIT must spin-off a controlled C REIT (section 1504(a)(2), *i.e.*, 80% or more).
- ◆ If D REIT distributes more than 80% but less than 100% of the stock of C REIT, the section 336(e) election may cause D REIT shareholders to have more dividend income than they would without the election.
 - ◆ However, benefit of the step-up on all of C REIT's assets may outweigh the detriment of additional gain recognition.

Temp. Treas. Reg. § 1.337(d)-7T

- ◆ Treasury and the IRS were concerned that the combination of a tax-deferred spin-off by a C corporation of a C owning REIT-qualifying assets and a later merger of that C into an existing REIT would violate the policy behind the repeal of *General Utilities*.
- ◆ The spin-off/merger transaction did not appear to be prohibited by the PATH Act.
- ◆ Treasury and the IRS attacked the spin-off/merger transaction through the built-in gains tax.

Temp. Treas. Reg. § 1.337(d)-7T

- ◆ Temp. Treas. Reg. § 1.337(d)-7T
 - ◆ A C corporation engaging in conversion transaction (*i.e.*, makes a REIT election or transfers assets to a REIT in a tax-deferred transaction) within a ten-year period following a section 355 transaction is treated as making an election to recognize all of its built-in gain as of the conversion date.
 - ◆ If a REIT participates in a tax-deferred spin-off within 10 years of having engaged in a conversion transaction, then the REIT must recognize any remaining built-in gain in the year of the spin-off.

Temp. Treas. Reg. 1.337(d)-7T

- ◆ The deemed sale provisions apply if either the C corporation or a member of its “separate affiliated group” engage in a section 355 transaction with the 10-year period.
- ◆ The provisions also apply to any “successor” or “predecessor.”
 - ◆ Those terms are defined broadly to include entities that engage in certain tax-free transactions qualifying for section 381 treatment.

Temp. Treas. Reg. § 1.337(d)-7T

- ◆ Like the PATH Act, the Temporary Regulations have exceptions for TRS-on-REIT spin-offs and REIT-on-REIT spin-offs.
 - ◆ But the exception for REIT-on-REIT spin-offs in the Temporary Regulation applies only if both C and D
 - ◆ are REITs immediately after the section 355 transaction **and**
 - ◆ remain qualified as a REITs for the next two years.

Temp. Treas. Reg. 1.337(d)-7T

- ◆ The broad scope of the Temporary Regulations will trigger the deemed sale treatment even when the conversion transaction has only a very attenuated link to the section 355 transaction. See example in NAREIT comment letter.
- ◆ In addition, the built-in gain that may be recognized under the Temporary Regulations is not limited to the built-in gain at the time of the conversion transaction or the section 355 transaction.
- ◆ Temporary Regulations will require additional due diligence when, for example, a C corporation contemplating a REIT election acquires another C corporation.

Temp. Treas. Reg. § 1.337(d)-7T

- ◆ Built-In Gain Recognition Period.
 - ◆ Permanently reduced by the PATH Act to 5-years for S corporations.
 - ◆ When initially released, Temporary Regulations established a 10-year recognition period for REITs, decoupling for the recognition period for REITs and S corporations for the first time.
 - ◆ T.D. 9810 reversed course and amended the Temporary Regulations to apply a 5-year recognition period for REITs, same as for S corporations.

FIRPTA

FIRPTA

- ◆ PATH Act – Lifts barriers for investing into US real estate
- ◆ Qualified Foreign Pension Funds
- ◆ Portfolio investors
- ◆ Qualified shareholders
- ◆ Determination of domestically-controlled REIT status
- ◆ Other FIRPTA changes

Overview

- ◆ FIRPTA re-characterizes gain from the sale of United States real property interests (“USRPIs”) as US source effectively connected income (“ECI”)
- ◆ Exceptions to FIRPTA prior to the PATH Act:
 - ◆ Portfolio investment (no more than 5%) in publicly traded USRPHC stock
 - ◆ DC REIT stock
 - ◆ Less than 50% investments by foreign governments in stock of United States real property holding corporations (“USRPHCs”)
- ◆ These exceptions apply only to gain from sale of corporate stock

New FIRPTA Exemptions

- ◆ New FIRPTA exceptions under the PATH Act:
 - ◆ Qualified Foreign Pension Funds (“QFPFs”) - section 897(l)
 - ◆ Public REIT portfolio investment threshold increased to 10% - section 897(k)(1)
 - ◆ Qualified shareholder exception for investment in public and private REITs – section 897(k)(2)

QFPF

- ◆ A QFPF means any trust, corporation or other organization or arrangement that
 - ◆ Is created or organized under the law of a country other than the United States,
 - ◆ Is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered,
 - ◆ Has no single participant with a right to more than 5% of its assets or income,
 - ◆ Is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates, and
 - ◆ Is entitled to certain tax benefits on either contributions or investment income in its home country

Qualified Shareholder

- ◆ Qualified shareholder
 - ◆ Exempt from FIRPTA on gains from the sale of (public or private) REIT stock (regardless of percentage interest), and
 - ◆ Capital gain dividends and distributions under section 301(c)(3) , redemptions under section 302 and liquidations under section 331 are treated as ordinary dividends
- ◆ Limitation
 - ◆ FIRPTA exemption and dividend treatment do not apply to the extent of “applicable investors”
 - ◆ “Applicable investors” are investors that, directly or indirectly, hold more than 10 percent of the stock of any REIT in which the qualified shareholder invests

U.S. REIT Act

Portfolio Investors – 10% or less

- ◆ Proceeds from sale of publicly-traded REIT stock (0% tax)
- ◆ Dividends attributable to publicly-traded REIT's sale of USRPIs treated as dividends

TRS Ownership Limit

- ◆ Under current law, the total value of TRSs may not represent more than 25% of the value of the REIT's assets.
- ◆ This has been changed to no more than 20%, starting in 2018.

Prohibited Transactions Tax

- ◆ REIT's are subject to a penalty tax at a rate of 100% for prohibited transactions. Prohibited transactions are sales of property that was held for sale in the ordinary course of business.
- ◆ There is a sale harbor for sales of property that have been held for rental for 2 years.
 - ◆ Additional rules apply to the safe harbor.
 - ◆ One of the rules limits the safe harbor to sales of 7 properties or 10% of the adjusted basis of the REIT's assets per year.
 - ◆ The 10% safe harbor has been increased to 20% and now includes a 3-year averaging concept.

Capital Gains Dividends

- ◆ The amount that a REIT can designate as capital gains dividends or as qualified dividends distributed is limited to the amount of dividends actually paid in the taxable year.
- ◆ This provision limits the flexibility that REITs have had in designating dividends as capital gain in years where capital gains exceed earnings and profits.

REIT Debt Instruments

- ◆ Debt instruments issued by REITs that file with the SEC qualify as real estate assets for purposes of the 75% asset test.
 - ◆ Limited to 25% of the REIT's total assets.
 - ◆ Income from such debt instruments is qualifying income under the 95% but not the 75% gross income tests.
- ◆ This creates more equality between the treatment of a REIT holding debt and equity of another REIT.

Ancillary Personal Property

- ◆ Ancillary personal property leased in connection with the lease of real property and which does not exceed 15% of the fair market value of the real property is treated as a real estate asset under the 75% asset test.
- ◆ A debt instrument that is secured by both real and personal property will be treated as a mortgage if the personal property collateral does not exceed 15% of the total security value.
 - ◆ This decreases the likelihood that such an instrument would have to be bifurcated.

Hedging Transactions

- ◆ Hedges entered into to effectively unwind a hedge with respect to real property indebtedness is not gross income for purposes of the 75% and 95% gross income tests.
- ◆ A hedge is also still a qualifying hedge for REIT purposes even if not timely identified as such if the mitigation provisions under Treasury regulations apply.

Earnings & Profits

- ◆ E&P is not reduced by amounts not allowed in computing taxable income and which have not been allowed in any prior year.
- ◆ This provision reduces disparities between a REIT's taxable income and E&P, but more work in this area is still needed.

TRSs and Foreclosure Property

- ◆ TRSs are permitted to operate and market foreclosure property.
- ◆ This conforms the treatment of TRSs and Independent Contractors for purposes of the foreclosure property rules.

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NAREIT Alert (December 18, 2015)

NAREIT Alert Important Industry Updates from NAREIT

Dec. 18, 2015

Late on Dec. 15, Congressional leaders announced they had reached agreement on a \$650 billion year-end "tax extenders" package named the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act) that they [believe lays the groundwork](#) for Congress and the next President to consider comprehensive tax reform. On Dec. 17, the House of Representatives voted 318-109 to approve the measure, the Senate voted 65 to 33 on Dec. 18 to approve it, and President Obama signed the bill into law the same day. The leaders released the PATH Act's [statutory language](#), a [section-by-section summary](#), a [detailed summary](#) by the Joint Committee on Taxation and a [revenue estimate](#) of all provisions in the bill. Important elements of both FIRPTA and REIT reform are included in the PATH Act, and NAREIT commends the leadership for incorporating both the FIRPTA and the Update and Streamline REIT Act (U.S. REIT Act) changes that were discussed in the Dec. 8 [NAREIT Alert](#).

FIRPTA Reform

Foreign investors of any type will be able to double (5 percent to 10 percent) their investment in publicly traded U.S. REITs and certain other entities held by qualified shareholders that are exempt from the FIRPTA exit tax on gains from sale of stock and from capital gain distributions. The PATH Act also contains a useful presumption for listed REITs that will make it easier for them to be considered domestically controlled so as to be exempt from FIRPTA, effective on the PATH Act's date of enactment.

Foreign pension and retirement fund investments in U.S. REITs and real estate will no longer be subject to the FIRPTA exit tax on gains from sale of the property or REIT stock and from capital gain distributions. The PATH Act reflects some technical changes made from the Dec. 7 [proposal](#) released by Ways & Means Chairman Kevin Brady (R-TX) that clarifies the original intent to exempt foreign pension plans from FIRPTA for both sales of REIT stock as well as REIT capital gains distributions, whether or not that ownership is direct or through a partnership.

Both changes will apply to any disposition on and after the package's date of enactment and for any distribution by a REIT on or after the enactment date for which the REIT receives a dividends paid deduction for its taxable year ending after such date. The PATH Act also includes three revenue raising FIRPTA proposals that were included in the Senate Finance Committee's passage of [S. 915](#) on Feb. 11, 2015 that are described in detail in a [Senate Finance Committee Report](#).

U.S. REIT Act

As described in more detail in the Dec. 8 [NAREIT Alert](#), the PATH Act would include almost all of the provisions in the U.S. REIT Act that was introduced by Representatives Pat Tiberi (R-OH) and Richard Neal (D-MA) in 2012.

These provisions will improve safe harbors from the dealer sales rules; repeal the preferential dividend rules for both listed and public non-listed REITs and provide the IRS with the authority to provide relief to private REITs from these antiquated rules (effective for distributions in taxable years beginning after Dec. 31, 2014); enhance the ability of taxable REIT subsidiaries (TRSs) to provide certain services; eliminate potential double taxation of earnings and profits; enhance the ability of REITs to hold certain debt assets of listed and public non-listed REITs; enhance the ability of REITs to hold certain ancillary personal property; and improve certain REIT hedging abilities. One important change from the Dec. 7 proposal is that another one of the U.S. REIT Act proposals to expand certain services that a timberland REIT TRS can provide was included in the PATH Act.

Other than the preferential dividend changes as described above, the U.S. REIT Act changes will apply to post-2015 taxable years.

REIT Spin-offs

Under the PATH Act, C corporations will no longer be able to spin off REITs in a tax-free transaction, but REITs will be able to spin off REITs and their TRSs held for at least three years on a tax-free basis. The PATH Act includes a technical change that clarifies that a TRS can be spun off on a tax-free basis even if the REIT holds the TRS through a partnership which it controls or if the TRS creates a new TRS to effectuate the spin transaction.

The PATH Act also includes a transition rule permitting a tax-free spin-off for companies which had filed prior to Dec. 7 with the IRS for a private letter ruling related to such a spin-off plan so long as the request has not been withdrawn, issued or denied as of that date.

In addition, beginning in post-2017 taxable years, the permissible size of TRSs will be reduced from 25 percent to 20 percent.

The proposal contained in the Dec. 7 proposal to limit contingent rents discussed in the Dec. 8 [NAREIT Alert](#) is not included in the PATH Act.

Other Real Estate Provisions

Finally, the PATH Act: 1) makes permanent: a) the 15-year depreciation period for leasehold improvements for property placed in service after Dec. 31, 2014; and, b) the 5-year (rather than 10-year) holding period for built-in gain tied to the conversion of a C corporation to an S corporation (and by extension to a REIT), effective in taxable years beginning after Dec. 31, 2014; and, 2) extends for two years the section 179D deduction for energy efficient commercial buildings while updating that section's ASHRAE standards, retroactively for 2015, and then for 2016.

Contact

For further information, please contact NAREIT's Executive Vice President & General Counsel, Tony Edwards, at tedwards@nareit.com; NAREIT's Senior Vice President, Policy & Politics, Cathy Barre, at cbarre@nareit.com; or NAREIT's Vice President & Senior Tax Counsel, Dara Bernstein, at dbernstein@nareit.com.

NAREIT Alert (December 8, 2016)

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NAREIT Alert Important Industry Updates from NAREIT

On Dec. 6, 2016, House Ways and Means Chairman Kevin Brady (R-TX), along with incoming Ranking Member Richard Neal (D-MA), introduced [H.R. 6439](#), the [Tax Technical Corrections Act of 2016](#). A companion bill, [S. 3506](#), also was introduced by Finance Committee Chairman Orrin Hatch (R-UT) and Ranking Member Ron Wyden (D-OR). Separately, the Joint Committee on Taxation issued a [technical explanation](#) of the bill.

H.R. 6439 revises and updates the provisions in H.R. 4891, the [Technical Corrections Act of 2016](#), which was introduced on April 11, 2016. As further described below, H.R. 6439 includes a number of technical corrections supported by NAREIT with respect to the Foreign Investment in Real Property tax Act (FIRPTA) and Update and Streamline REIT Act (U.S. REIT Act) provisions in the [Protecting Americans from Tax Hikes Act of 2015](#) (PATH Act) both informally and via [written submission](#). It also includes clarifications to the new partnership audit rules, enacted as part of the Bipartisan Budget Act of 2015.

H.R. 4891

By way of background, H.R. 4891 included two NAREIT-suggested changes. Specifically, Internal Revenue Code (Code) section 897(h)(4)(B) defines the term "domestically controlled qualified investment entity" as any qualified investment entity (e.g., a REIT or certain regulated investment companies) less than 50% of the value in which at all times during the testing period is held by foreign persons. The PATH Act had included special rules relating to this provision that went into effect on Dec. 18, 2015, the PATH Act's date of enactment. H.R. 4891 would clarify the effective date for the determination of domestic control by stating that the rule applies with respect to each testing period ending on or after the date of enactment (not that the rule takes effect on the date of enactment, as stated in the PATH Act). Second, H.R. 4891 would remedy a number of incorrect cross references in Code section 856.

Additionally, H.R. 4891 would modify the definition of a qualified collective investment vehicle that is eligible for benefits of a comprehensive income tax treaty with the United States that includes an exchange of information program (such investment vehicle would be exempt from FIRPTA). As clarified, the definition could be met only if the dividends article in the treaty imposes conditions on the benefits allowable in the case of dividends paid by a REIT.

H.R. 6439

In addition to the changes listed above, H.R. 6439 would make a number of other changes of interest, including several originated by NAREIT.

Ancillary Personal Property Clarifications

H.R. 6439 would modify the rules concerning personal property leased on or mortgaged along with real property. The PATH Act treats ancillary personal property as a real estate asset for purposes of the REIT 75% asset test to the extent that rents attributable to such ancillary personal property are treated as rents from real property. H.R. 6439 would make the following [NAREIT-requested](#) changes. First, it would treat gain from the sale or disposition of such ancillary personal property as gain from the sale or disposition of a real estate asset for purposes of the REIT income tests. Additionally, H.R. 6439 would treat gain from the sale or disposition of certain obligations secured by mortgages on both real property and personal property as gain from the sale or disposition of real property for purposes of the REIT income tests.

FIRPTA/Qualified Foreign Pension Fund Clarifications

Under the PATH Act, the FIRPTA rules of Code section 897 do not apply to any United States real property interest held directly (or indirectly through 1 or more partnerships) by, or to any distribution received from a real estate investment trust by: A) a qualified foreign pension fund; or, B) any entity all of the interests of

which are held by a qualified foreign pension fund. NAREIT had requested a technical correction to confirm that the qualified foreign pension fund exception from FIRPTA applies even if several qualified foreign pension funds own an entity that holds a REIT (rather than just one qualified foreign pension fund owns the entity that itself owns all of the interests in a REIT).

H.R. 6439 would clarify that a qualified foreign pension fund is not treated as a nonresident alien individual or as a foreign corporation. As the Joint Committee explanation points out, "in other words, in determining the U.S. income tax of a qualified foreign pension fund, Code section 897 does not apply." This change appears to address the issue raised by NAREIT above. Additionally, H.R. 6439 would treat an entity all the interests of which are held by a qualified foreign pension fund (e.g., a corporation) as such a fund that is exempt from FIRPTA.

H.R. 6439 would make additional changes to the five-pronged definition of "qualified foreign pension fund." It would clarify that a government-established fund to provide public retirement or pension benefits may qualify, as well as a fund established by more than one employer to provide retirement or pension benefits to their employees (including self-employed individuals), such as a multiple-employer or multiemployer plan. NAREIT had requested a clarification that government funded retirement arrangements (similar to individual retirement accounts in the U.S.) could constitute qualified foreign pension funds notwithstanding that the employer is not the sponsor of the pension fund. In addition, H.R. 6439 would make a number of other clarifying changes to the qualified foreign pension fund definition.

Partnership Audit Changes

H.R. 6439 also would clarify that a partnership may "push out" adjustments to partners through tiered partnerships in lieu of paying tax at the partnership level. The bill also includes provisions related to the calculation of an imputed underpayment as well as new provisions related to penalties.

H.R. 6439 does not mention the REIT deficiency dividend procedure. According to the [General Explanation of Tax Legislation Enacted in 2015](#) (JCT Blue Book), guidance coordinating the new partnership audit adjustments with the deficiency dividend rules is expected to be issued by the Treasury Department.

The legislation is likely not going to pass in the few remaining legislative days this year but can be used by practitioners and the Treasury Department as a basis for construing Congressional intent.

Please contact [Tony Edwards](#), [Cathy Barre](#), or [Dara Bernstein](#) to discuss any questions about this legislation.

May 16, 2016

VIA ELECTRONIC SUBMISSION [www.regulations.gov]

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2016-26)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: [Notice 2016-26](#): Request for Comments Regarding
Recommendations for Items that Should be Included on the 2016-
2017 Priority Guidance Plan

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts®
(NAREIT) appreciates the opportunity to offer our suggestions
regarding regulatory guidance to be placed on the 2016-17
Priority Guidance Plan (PGP).

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. NAREIT's members are REITs and
other businesses throughout the world that own, operate, and
finance income-producing real estate, as well as those firms and
individuals who advise, study, and service those businesses.

EXECUTIVE SUMMARY

These areas of guidance largely relate to clarifications under the
Protecting Americans from Tax Hikes Act of 2015 (the PATH
Act), which was enacted as part of Pub. Law 114-113, the
“Consolidated Appropriations Act, 2016,” and signed into law on
December 18, 2015.

The PATH Act included legislative provisions derived from the
“Update and Streamline REIT Act” ([H.R. 5746](#), introduced in
2012, the U.S. REIT Act); changes to the Foreign Investment in
Real Property Tax Act (FIRPTA) derived from [H.R. 2128](#); and,
changes to the rules regarding tax-free spin-offs of REITs derived
from [H.R. 1](#) as introduced in the 113th Congress. The potential
areas of regulatory guidance needed are set forth below under a
separate heading for each of those items. In particular, NAREIT

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believes that the preferential dividend and the qualified foreign pension fund (QFPF) issues are the greatest priorities for regulatory guidance.

More specifically, NAREIT requests that the Department of the Treasury and the Internal Revenue Service include in their 2016-17 PGP the following ten items:

- 1) guidance that clarifies and interprets the repeal and remediation of the preferential dividend rule in section 562(c) by i) considering REIT subsidiaries of publicly offered REITs as part of the PATH Act's repeal of the preferential dividend rules for publicly offered REITs; and, ii) issuing a revenue procedure that lists several of the most common inadvertent fact patterns as coming under a *de minimis* exception so as not to be considered as preferential dividends and that sets forth a process under which REITs can remedy other preferential dividends by self-assessing a \$50,000 penalty (a draft revenue procedure is attached for the government's consideration);¹
- 2) guidance regarding earnings and profits (E&P) for dividends distributed after the close of a taxable year intended to carry out Congressional intent to avoid the duplicative taxation of REIT shareholders;
- 3) guidance, for purposes of section 856(c)(5)(A), regarding the determination of a REIT's proportionate interest in debt issued by a partnership in which it owns an interest to be consistent with the principles of Treas. Reg. § 1.856-3(g);
- 4) guidance regarding the determination of ancillary personal property for purposes of section 856(c)(9);
- 5) guidance clarifying the meaning of certain terms under sections 856(c)(7)(C)(v) and (D)(v);
- 6) issuance of a revised Form W-8 that would: i) more efficiently permit eligible non-U.S. persons to claim exemption from FIRPTA withholding, including exemption from sales made by QFPFs; and, ii) allow pass-through entities to rely upon the non-U.S. person's certification of exempt status to prevent erroneous withholding at the pass-through entity level;
- 7) guidance regarding the treatment of USRPIs held, or distributions received from a REIT, by a QFPF;
- 8) guidance clarifying the definition of QFPF;

¹ Unless otherwise noted, references to "section" in this letter refer to sections of the Internal Revenue Code of 1986, as amended (the Code).



9) guidance clarifying the definition of “predecessor” for purposes of the FIRPTA Cleansing Exception (as defined below); and,

10) guidance confirming that, because a timely REIT election for a particular taxable year is due (with extensions) in September of the following year, for purposes of section 355(h)(2)(A) a distributing and a controlled corporations are REITs “immediately” after the distribution so long as a timely REIT election for such taxable year is filed.

DISCUSSION

A. U.S. REIT Act Provisions

1. Guidance that clarifies and interprets the repeal and remediation of the preferential dividend rule in section 562(c)

Prior to the PATH Act, all REITs were subject to what is known as the “preferential dividend” rule. In particular, under section 857(a)(1), the REIT’s deduction for dividends paid generally must equal or exceed 90% of its taxable income. Prior to the PATH Act, 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.

Consistent with the recommendations contained in the last several Administration budget proposals,² 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 (34 Act). For other REITs, the PATH Act added section 562(e)(2), applicable to distributions in taxable years beginning after December 31, 2015, which provides:

In the case of a failure of a distribution by a real estate investment trust to comply with the requirements of subsection (c), the Secretary may provide an appropriate remedy to cure such failure in lieu of not considering the distribution to be a dividend for purposes of computing the dividends paid deduction if—
(A) the Secretary determines that such failure is inadvertent or is due to reasonable cause and not due to willful neglect, or

² See, e.g., [General Explanations of the Administration’s Fiscal Year 2016 Revenue Proposals](#) at page 265 (Green Book).



(B) such failure is of a type of failure which the Secretary has identified for purposes of this paragraph as being described in subparagraph (A).

NAREIT respectfully requests three pieces of guidance with respect to the PATH Act's preferential dividend rule repeal and grant of remediation authority. First, as it is not unusual for publicly offered REITs to own one or more "subsidiary REITs",³ the repeal of the preferential dividend rule should be applicable to a subsidiary REIT of a publicly offered REIT if the parent REIT and subsidiary REIT file consolidated financial statements with the SEC under generally accepted accounting principles (GAAP).

The PATH Act provision for publicly offered REITs clearly recognized the transparency that filing under the 34 Act provides to publicly offered REITs and their shareholders. Given that the same transparency applies in the case of a subsidiary entity consolidated pursuant to GAAP (and therefore the same internal controls apply to both entities), it would be helpful if the IRS and Treasury conclude that the preferential dividend rule similarly does not apply to a subsidiary REIT consolidated under GAAP with a parent publicly offered REIT.

Second, NAREIT recommends that the IRS and Treasury Department adopt a revenue procedure, similar to the sample revenue procedure attached to this letter, that contains examples of common, *de minimis* items that should not be considered violations of the preferential dividend rule. NAREIT recommended adoption of a [similar revenue procedure](#) in 2007 and 2010 submissions to the IRS and Treasury Department. Since then, NAREIT has become aware of additional *de minimis* items that should be covered by a revenue procedure, while some previously included items have become mooted on account of the PATH Act's repeal of the preferential dividend rule for publicly offered REITs. Accordingly, some additional items are included in the attached revenue procedure, and mooted items have been removed.

Third, in step with the mechanics for other relief provisions in sections 856 and 857, NAREIT recommends that a system of self-reporting and self-remediation apply to violations of the preferential dividend rule that are beyond the *de minimis* items covered by the revenue procedure above. Specifically, in the case of preferential dividend rule violations not listed by the revenue procedure (or future supplemental revenue procedures that list other common, non-consequential fact patterns) and that are inadvertent or that are due to reasonable cause and not due to willful neglect, the amount the REIT distributed nevertheless would qualify for

³ The IRS has issued several private letter rulings involving subsidiary REITs. *See, e.g.*, PLRs [201614009](#); [201518010](#); [200813009](#) and [200625019](#). Further, the presumption of ownership made by the PATH Act in section 897(h)(4)(E)(i) and (ii) recognizes the use of subsidiary REITs by listed REITs.



the dividends paid deduction, provided that once the failure is identified: i) the REIT's next federal income tax return includes a statement describing the inadvertent failure or the basis on which the failure was due to reasonable cause and not due to willful neglect, along with a certification under penalty of perjury by the person signing the return; ii) the REIT takes appropriate action, if any, to remedy the potentially preferential dividend; and, iii) the REIT pays a penalty of \$50,000 with the return.

We recommend that this process should provide that, if the same or a substantially similar failure has occurred with respect to multiple distributions before being identified as a preferential dividend rule violation, and if the REIT's self-reporting is made before the failures are discovered by the IRS, then the REIT shall be considered to have had a single failure for purposes of exacting the \$50,000 self-remediation penalty.

NAREIT is hopeful that as the IRS learns (*e.g.*, through self-assessment filings or closing agreements) of additional examples of *de minimis* actions that could give rise to preferential dividends, it would supplement this revenue procedure appropriately.

2. Guidance regarding E&P for dividends distributed after close of taxable year

a. Overview.

As further described below, the PATH Act amended the calculation of E&P for REITs and their shareholders. Pursuant to the PATH Act, there is now a separate calculation of E&P for a REIT and for its shareholders. However, there is the potential for some ambiguity as to which amount of E&P applies in the case of section 857(b)(9), section 858 and consent dividends. NAREIT recommends that the appropriate E&P for purposes of the foregoing provisions should be the REIT's E&P calculation.

b. PATH Act Provisions.

In Section 320 of the PATH Act, Congress modified the REIT-specific E&P rules in sections 562(e) and 857(d)(1) that operate as an overlay to the E&P rules generally applicable to C corporations. Congress retained, with minor modification, the rules (the DPD Computation) that address how a REIT computes current E&P for purposes of determining its dividends paid deduction (DPD). Under sections 316 and 562(a), a distribution is generally treated as a dividend only to the extent that it is made out of E&P. The DPD Computation permits a REIT to get a DPD for a distribution that offsets its full taxable income even when, for example, absent the DPD Computation, i) the REIT's gain from



the sale of real estate for regular tax purposes would be greater than the amount of such gain for E&P purposes; or, ii) a deduction would reduce E&P but not be allowable for determining taxable income of the current year.

At the same time, Congress modified the rules that determine how a distribution is treated in the hands of REIT shareholders (the 301 Computation). Under section 301, a distribution is generally taxed as a dividend to the shareholder to the extent of the corporation's E&P; amounts in excess of E&P are treated as a return of capital to the extent of the shareholder's basis, and any remainder is taxed as capital gain. Previously, the part of the DPD Computation that related to real estate gains applied only for DPD purposes, not for determining the extent to which shareholders were treated as receiving a dividend under section 301; the part of the DPD Computation that addressed amounts deductible for E&P purposes but not allowable for regular tax purposes applied to determining E&P for both DPD purposes and shareholder dividend purposes.

This latter approach, while it achieved the worthy objective of permitting a REIT to offset all of its taxable income, unfortunately resulted in the shareholders being taxed twice on what was essentially the same E&P. Section 320 of the PATH Act avoids this result in most situations⁴ by permitting amounts to reduce E&P for purposes of the 301 Computation where such amounts were allowed in computing taxable income in prior taxable years. In other words, the 301 Computation causes current E&P to be reduced in this circumstance, reducing the amount taxable to shareholders as dividends and thereby eliminating the duplicative taxation at the shareholder level.

c. *The needed clarifications.*

The differences between the DPD Computation and the 301 Computation are a sensible way to retain the basic E&P rules while both permitting REITs to offset the full amount of their taxable income and not penalizing REIT shareholders by taxing more than an appropriate amount of the distributions as dividends. The dichotomy between the DPD Computation and the 301 Computation, which existed to an extent under prior law but has now been expanded by the PATH Act,

⁴ The new rules avoid duplicative taxation in situations when the amount is allowable for regular tax purposes prior to the time it is deductible for E&P purposes. This would include, for example, any type of accelerated depreciation. However, because the operative language in section 857(d)(1)(B) permits the reduction of E&P when the amounts have been allowable in computing regular taxable income in *prior* years, it does not appear to cover situations where the E&P deduction precedes the regular tax deduction. This occurs in the case of the limitation on capital losses and the section 163(j) limitation on deducting interest. It appears possible to rectify such duplicated inclusions, at least to an extent, by revising Treas. Reg. § 1.857-7(b). While this issue is certainly worth addressing, it is not as time-sensitive as the issues addressed here and might require a change to regulations.



does, however, raise an issue as to the operation of certain other provisions relating to REIT distributions.

Sections 857(b)(9), 858, and 565 all provide REITs with some flexibility in the manner or timing of meeting their distribution requirements. Section 857(b)(9), the “January Dividend Rule”, specifically provides that a “*dividend* declared by a [REIT] in October, November, or December of any calendar year and payable to shareholders of record on a specified date in such a month” causes an amount distributed in January of the following year to be treated as having been distributed on December 31 of the prior year.⁵ Section 858 allows distributions in a year to be treated for DPD purposes as having been made in the prior year. Finally, section 565 permits REIT shareholders to consent to dividends; even though there is no actual cash distribution, the REIT is treated for DPD purposes as having paid the distribution on December 31 of the year, and the shareholders are treated as if they had received an actual distribution on this date and then recontributed the cash to the REIT.

The first two provisions are regularly employed by both publicly offered REITs and private REITs; the third provision is as a practical matter confined to private REITs, but it is often used for subsidiary REITs that are owned by publicly offered REITs. The availability of these three provisions thus is significant to all REITs.

In the case of sections 858 and 565, the operation of the provisions is clearly limited to the E&P in the year for which the distribution is treated as resulting in a DPD. The use of the term “dividend” in section 857(b)(9) could suggest “that it, too, is subject to this same limitation. The fact that there are now two ways to compute the E&P of a REIT, the DPD Computation and the 301 Computation, therefore creates possible confusion as to which of these computations should apply in connection with sections 857(b)(9), 858 and 565.

The clear answer is that these three provisions should all look to E&P as calculated by the DPD Computation. The basic premise for each of these provisions is that it should facilitate a REIT’s distributing the full amount of its taxable income. In those cases when the DPD Computation and the 301 Computation are different, the 301 Computation is always lower, in order to achieve the objective of not duplicating the amounts treated as dividends to shareholders when the shareholders already picked up this income in prior years. Given that the payment of actual dividends during a taxable year will result in a situation when the REIT’s DPD will exceed the amount the shareholders treat as

⁵ Section 857(b)(9) specifically uses the term “dividend.” Section 316 defines “dividend” generally as any distribution out of accumulated or current E&P. Thus, one may suggest that a REIT only can distribute a “January Dividend” to the extent that the amount distributed in January does not exceed the prior year’s current and accumulated E&P.



an ordinary dividend that year, it makes no sense to restrict a REIT's utilization of these three provisions to amounts that will be taxable to shareholders as dividends. This cannot be the result Congress intended in amending the E&P rules. This would also be directly counter to the objective that Congress was furthering when it retained the DPD Computation so that REITs can pay out amounts as dividends, and be entitled to the DPD, even though the amounts, absent the special E&P rule for REITs, would otherwise exceed what can be paid out of E&P.

Because the new E&P rules are effective for calendar 2016, and because the amounts that a REIT must distribute in 2016 depend in part on how sections 857(b)(9), 858, and 565 operate, it is imperative that the IRS and Treasury clarify that these provisions all look to the DPD Computation of E&P. This could be accomplished in a revenue ruling or perhaps a revenue procedure.

At the same time, it would make sense to address how the amounts that are dividends for DPD purposes but not for shareholder purposes are reported to shareholders. Suppose, in each of the following examples, a REIT had \$100 of taxable income and E&P in each of five consecutive taxable years (determined without regard to any energy efficient commercial building deduction and without regard to any deduction for dividends paid). Assume that in the first of the five years, the REIT had an energy efficient commercial building deduction in computing its taxable income of \$10, reducing its pre-dividend taxable income to \$90. Assume further that the deduction is allowable at a rate of \$2 per year over the five-year period beginning with the first year in computing its E&P. The REIT's current E&P under the DPD Computation and 301 Computation are as follows:

	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
DPD Computation	98	100	100	100	100
301 Computation	98	98	98	98	98

Assume the REIT distributes \$100 to its shareholders in 2015 and \$80 in cash during 2016. Assume further that the REIT declares in December 2016 a distribution of \$20, payable to shareholders of record on December 15, and it actually distributes \$20 in January 2017, the results should be as follows:

- the entire \$20 distribution is treated as having been paid on December 31, 2016 (*i.e.*, E&P as calculated by the DPD Computation);
- the REIT gets a DPD in 2016 for \$20 with respect to this distribution; and,



- the shareholders are treated as having received, in 2016, \$98 of dividends and a return of capital of \$2.

If, instead of utilizing section 857(b)(9), the REIT chooses to use section 858, the REIT would designate \$20 of distributions in 2017 to be taken into account for DPD purposes in 2016. The results should be as follows:

- the REIT gets a DPD in 2016 of \$20 with respect to the 2017 distribution; and
- the shareholders are treated as receiving, in 2017, a dividend of \$18 and a return of capital of \$2.

It is worth pointing out that even if the REIT has taxable income and E&P in 2017, that fact should not change the above treatment of the \$2 return of capital, for two reasons. First, while the \$2 is not an ordinary dividend to the shareholders, it will in fact be immediately taxable to them to the extent, if any, that it exceeds their basis, and if not it will reduce the basis in their stock. Second, if this \$2 were treated as a 2017 distribution, the REIT would receive two DPDs for the same distributable amount, which seems inappropriate.

Finally, assume that instead of either of the above, the shareholders consent to a \$20 consent dividend for 2016. This should be permissible because, under the DPD Computation, the REIT has \$20 of undistributed E&P. The results should be as follows:

- the entire \$20 distribution is treated as having been paid on December 31, 2016
- The REIT gets a DPD for 2016 of \$20 by reason of the consent dividend; and
- the shareholders are treated as having received, in 2016, pursuant to the consent dividend, a dividend of \$18 and a return of capital of \$2.

To make consent dividends, the shareholders would have to execute Forms 972, but the Form 972 would have to be revised to permit the shareholders to agree to the inclusion of \$18 as ordinary dividend and \$2 as return of capital.

Alternatively, and until it is possible to revise the Form 972, shareholders should be permitted to attach a statement to the form explaining the situation. The Form 972s are sent by the shareholders to the REIT, and the REIT files the Forms 972 along with the Form 973 that the REIT itself must fill out. For this reason, and because the REIT can easily instruct shareholders how the Forms 972 should be



filled out and what they should report on their own tax returns, this process would not appear to be problematic as an administrative matter.

In conclusion, it is worth emphasizing that because sections 857(b)(9), 858, and 565 affect the 2016 DPD, their interpretation affects REIT operations during 2016. It is critical for REITs to be able to assess whether property sales in 2016 or depreciation deductions allowed in 2016 for E&P purposes will or will not affect the availability of these three provisions to supplement the amount of actual cash distributions made in 2016. There does not appear to be any policy reason that would be served by requiring these three provisions to look to the 301 Computation rather than the DPD Computation, and the sooner there can be certainty in this regard, the better.

3. Guidance that clarifies, for purposes of section 856(c)(5)(A), that a partner will be viewed as issuing debt issued by a partnership to the extent of its proportionate interest in that partnership (calculated under Treas. Reg. § 1.856-3(g))

The PATH Act expands the term “real estate asset” to include debt instruments (not otherwise real estate assets) issued by publicly offered REITs.

Most listed equity REITs are known as Umbrella Partnership REITs (UPREITs) because they conduct substantially all of their business and own substantially all of their assets through subsidiary operating partnerships, which usually are the issuers of unsecured debt and are regarded as entities separate from the REITs for U.S. federal income tax purposes.⁶ Further, Treas. Reg. § 1.856-3(g) provides that:

In the case of a [REIT] which is a partner in a partnership, as defined in section 7701(a)(2) and the regulations thereunder, the trust will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets shall be determined in accordance with his capital interest in the partnership.

NAREIT recommends that, for purposes of applying section 856(c)(5)(A), in the case of debt issued (for corporate law purposes) by a flow-through entity of a REIT, the REIT be viewed consistent with the principles of Treas. Reg. § 1.856-3(g) as the issuer of such debt.

⁶ See Treas. Reg. § 1.701-2(d) Example 4 which describes an UPREIT as an example of the type of structure that falls outside the scope of the partnership anti-abuse regulations.



4. Guidance that clarifies, for purposes of the ancillary personal property rule of section 856(c)(9), the measurement of ancillary personal property under section 856(d)(1)(C)

In order to maintain REIT status, section 856(d)(1)(C) provides that “rents from real property” includes rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such property for the taxable year does not exceed 15% of the total rent for the *taxable year* attributable to both the real and personal property leased under, or in connection with, such lease.

Section 318 of the PATH Act adds to the Code a new section 856(c)(9), which provides that “[p]ersonal property shall be treated as a real estate asset for purposes of paragraph (4)(A) to the extent that rents attributable to such personal property are treated as rents from real property under subsection (d)(1)(C).”

“Rents from real property” for purposes of the REIT gross income test is typically calculated on an annual, rather than quarterly, basis. On the other hand, the REIT asset test, and accordingly, new section 856(c)(9)’s definition of ancillary personal property for purposes of the asset test, is a quarterly test. Thus, there appears to be a mismatch.

To reconcile these two provisions, NAREIT recommends an easily administrable test under which a REIT uses the prior year-end’s determination that rents from personal property was treated as rents from real property under section 856(d)(1)(C) for purposes of the following year’s section 856(c)(9) determination. NAREIT is also open to any reasonable reconciliation of section 856(c)(9) and section 856(d)(1)(C).

5. Guidance that defines various terms under sections 857(b)(6)(C)(v) and (D)(v) (Dealer Sales Safe Harbor)

Under Section 857(b)(6), a REIT is subject to a 100% tax on net income derived from a “prohibited transaction,” which is defined as a sale or other disposition of property described in Section 1221(a)(1) that is not foreclosure property (*i.e.*, property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business). Sections 857(b)(6)(C) (and its corresponding provision in the timber context, section 857(b)(6)(D)) provide safe harbor rules in determining if a sale constitutes a prohibited transaction. The PATH Act expands on some of these safe harbor rules.

Section 857(b)(6)(C) excludes a sale of a real estate asset from the term “prohibited transaction” if the following requirements are met:



- (i) the REIT has held the property for not less than 2 years;
- (ii) the aggregate expenditures made by the REIT, or any partner of the REIT, during the 2-year period preceding the date of sale which are includible in the basis of the property do not exceed 30% of the net selling price of the property;
- (iii) (I) during the taxable year the REIT does not make more than 7 sales of property (other than sales of foreclosure property or sales to which Section 1033 applies), or (II) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which Section 1033 applies) sold during the taxable year does not exceed 10% of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year, or (III) the fair market value of property (other than sales of foreclosure property or sales to which Section 1033 applies) sold during the taxable year does not exceed 10% of the fair market value of all of the assets of the REIT as of the beginning of the taxable year, or (IV) the REIT satisfies the requirements of subclause (II) applied by substituting "20%" for "10%" and the 3-year average adjusted bases percentage for the taxable year (as defined in subparagraph (G)) does not exceed 10%, or (V) the REIT satisfies the requirements of subclause (III) applied by substituting "20%" for "10%" and the 3-year average fair market value percentage for the taxable year (as defined in subparagraph (H)) does not exceed 10%;
- (iv) in the case of property, which consists of land or improvements, not acquired through foreclosure (or deed in lieu of foreclosure), or lease termination, the REIT has held the property for not less than 2 years for production of rental income; and,
- (v) if the requirement of clause (iii)(I) is not satisfied (*i.e.*, the REIT made more than 7 sales of property during the year), substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT itself does not derive or receive any income (IK) or a taxable REIT subsidiary (TRS).

Notably, the PATH Act liberalizes the scope of clauses (iii)(II), (iii)(III), and (v) by allowing a REIT to satisfy the 10% standard using a 3-year average of sales percentage, assuming that a REIT does not sell greater than 20% of the aggregate



bases or value of its portfolio in any one year, and by allowing a REIT to make marketing and development expenditures either through a TRS or IK from which the REIT receives no income. Under prior law, if these expenditures had been made through a TRS, the safe harbor of section 857(b)(6)(C)(v) could not have been satisfied.

Consider the situation in which in 1994, a REIT had engaged an IK to develop rental property (the Property) for the REIT's own account. The agreement (the Agreement) between the REIT and the IK provided that the IK would in fact develop the property based on the specifications in the Agreement. Although the REIT supervised the IK's general progress, the IK had control of the day-to-day decisions regarding materials, suppliers, subcontractors, construction employees, etc. The Agreement provided that the REIT would pay the IK for these development costs directly, it would reimburse the IK for certain of these costs, or in certain cases, it would disburse payment to a subcontractor or supplier at the direction of the IK. The IK completed the development of the Property in 1994, and the REIT has held the Property for rental purposes since that time.

In 2016, the REIT evaluates a potential sale of the Property and whether such a sale will satisfy the alternative safe harbor in section 857(b)(6)(C)(v). However, due to lack of existing guidance, it is not fully known how the alternative safe harbor test under section 857(b)(6)(C)(v) (and corresponding section 857(b)(6)(D)(v), in the case of a timber REIT) should be applied by the REIT.

For example, in determining whether a particular sale of real property has met the requirement of clause (v), that substantially all of the marketing and development expenditures with respect to the property were made through an IK or TRS, the REIT will need specific guidance regarding:

- 1) how to calculate the total amount of "marketing and development expenditures" with respect to Property. For example, over the past 22 years, the REIT has had to incur expenses to maintain and operate the property. Presumably, these costs would be excluded from "marketing and development expenditures."
- 2) how to calculate what portion of the total marketing and development expenditures were made "through" the IK.
- 3) once the total "marketing and development expenditures" are calculated, how to calculate "substantially all" of those expenditures. In other words, is "substantially all" 70% or 80% or some other percentage?

Presently, these concepts are not defined anywhere in the legislative history or IRS rulings. Unless these concepts are clarified by the IRS in future guidance,



either through private letter rulings or published guidance, section 857(b)(6)(C)(v) and section 857(b)(6)(D)(v) may have little practical usefulness to REITs.

It is clear that in the PATH Act Congress intended to expand the scope of the safe harbor rules under section 857(b)(6)(C), and, therefore, guidance on how these terms in clause (v) should be interpreted would make this alternative safe harbor test more meaningful. Thus, NAREIT requests that the IRS include in its Priority Guidance Plan a guidance item interpreting how the various terms in section 857(b)(6)(C)(v) and section 857(b)(6)(D)(v) should be applied.

NAREIT suggests that in determining whether the requirements of sections 857(b)(6)(C) and (D)(v) have been satisfied, the following definitions and meanings should be adopted and clarified in future IRS guidance: i) as further described below, the term “marketing expenditures” should include all expenses incurred by a REIT either directly or indirectly for the marketing of property for sale starting with the REIT’s decision to market the property and ending when the buyer is either selected or the decision to sell is abandoned by the REIT, and the term “development expenditures” should include amounts incurred for construction and reconstruction of property (*i.e.*, development may take the form of new construction on raw land or redevelopments or build outs of existing properties owned by the REIT), but should exclude acquisition costs and costs to maintain or operate the property; ii) amounts disbursed by the REIT, including cost of land and material, at the direction of the IK (from whom the REIT receives no income), or at the direction of a TRS, to pay for general contractors, subcontractors, suppliers etc., in connection with the development of property (even if disbursed directly to such third parties at the direction of the IK or TRS) should be treated as marketing or development expenditures made through an IK or TRS provided that such payments are made pursuant to an agreement between the REIT and the IK or TRS for the marketing or development of the property and under their instruction and control; and, iii) a specific value, such as 80%, should be assigned to the term “substantially all” for purposes of calculating “substantially all of the marketing and development expenditures” for purposes of sections 857(b)(6)(C)(v) and (D)(v).

a. *Marketing and Development Expenditures.*

NAREIT recommends that the IRS provide a specific definition of the term “marketing expenditures. NAREIT believes that, for purposes of section 857(b)(6)(C)(v), “marketing expenditures” should include all expenses incurred by a REIT either directly or indirectly for the marketing of property for sale starting with the REIT’s decision to market the property and ending when the buyer is either selected or the decision to sell is abandoned by the REIT.



For example, marketing expenditures should include expenditures for determining potential buyers, sales price, expenses in putting together due diligence and environmental reports, and marketing studies, as well as broker's commissions for listing the property. Further, an amount paid by a REIT to a third party broker or agent for marketing property for sale would include direct costs and reimbursements of expenses. In addition, as discussed below, any amount required to be paid by a REIT at the direction of a sales agent or broker or another party should be treated as paid "through the IK or TRS" for purposes of clause (v), whether the amount is paid directly by the REIT or indirectly by the REIT through an IK or TRS who in turn pays others.

Once the agreement to sell a property has been made, expenditures for the acquisition, improvement, operation, and sale of the property would not be "marketing expenditures" and should be excluded from the definition of "marketing expenditures." Similarly, maintenance costs of the property, legal fees, escrow fees, and title fees relating to the negotiations with the buyer and the closing of the sale would not be "marketing expenditures," as these expenses no longer relate to marketing, but to the actual closing of the sale of the property.

Additionally, NAREIT suggests that the IRS define the term "development expenditures" to include amounts incurred for construction and reconstruction of property (*i.e.*, development may take the form of new construction on raw land or redevelopments or build outs of existing properties owned by the REIT) but to exclude acquisition costs and costs to maintain or operate the property. Further, development expenditures should exclude costs for the marketing or sale of the property.

b. *Made "through" an IK or TRS.*

The requirement that expenditures be made "through" an IK or TRS seems to be part of a requirement that the REIT be passive with respect to the marketing and development expenditures and act through other third parties rather than using its own employees. Thus, so long as any disbursements by the REIT are made at the direction and under the control of the relevant IK or TRS, these disbursements should be viewed as having been made "through" the IK or TRS, as appropriate. Clarification that payments disbursed by REIT to third party suppliers, for example, at IK's direction and control, would make this safe harbor more useful.

For example, assume that a REIT hired IK to construct a building. Under the agreement, IK is entitled to a fee equal to 20% of the construction costs. Pursuant to the agreement, IK orders lumber costing \$100. The REIT could pay \$120 to IK with IK paying \$100 to the lumberyard or the REIT could pay \$20 to IK and pay \$100 directly to the lumberyard. For purposes of section 857(b)(6)(C)(v), the



\$120 expenditure by the REIT should be treated the same, *i.e.*, as an expenditure made through an IK.

c. “*Substantially All.*”

NAREIT recommends that the term “substantially all,” for purposes of section 857(b)(6)(C), be defined with a specific percentage, such as 80% or more. Although NAREIT recommends an 80% or more test, NAREIT has no objection to any reasonable interpretation of the term “substantially all.” As described further below in the discussion under FIRPTA, any reasonable standard would provide greater clarity than current law.⁷

In applying section 857(b)(6)(C)(v), a REIT first should determine the total amount of marketing and development expenditures with respect to the property. Then, in determining whether the “substantially all” requirement has been met, the REIT should compare the marketing and development expenditures made through an IK or TRS to the total marketing and development expenditures.

B. FIRPTA Provisions

FIRPTA treats any gain from a non-U.S. person’s sale of a U.S. real property interest (USRPIs) as if the non-U.S. person were doing business in the United States, and therefore subjects that gain to full U.S. income tax as well as full filing requirements. To enforce the FIRPTA regime, the Code requires U.S. persons who acquire real property from non-U.S. investors to withhold 15% of the gross proceeds (up from 10% prior to the PATH Act) or 35% in the case of certain distributions by a REIT, and remit withheld amounts to the IRS. FIRPTA taxation applies both to sales of direct interests in U.S. real estate as well as to sales of shares of corporations the assets of which primarily consist of U.S. real estate (United States Real Property Holding Corporations, or USRPHCs).

Recognizing that “portfolio” investors of listed real estate companies, such as REITs, are more akin to securities owners than to direct real estate investors, since its inception in 1980 FIRPTA provides a limited exception for sales of stock in a USRPHC that is regularly traded on an established securities market (so long as the seller owns 10% or less of that company in the case of REITs, up from 5% or less prior to the PATH Act with respect to all listed USRPHCs) and sales of stock in a domestically controlled REIT. Additionally, since 2004 REIT capital gains distributions have been subject to an up-to-35% FIRPTA withholding tax unless they are paid to 5% (10% after the PATH Act) or less shareholders of a publicly traded REIT, in which case the distributions are subject to the same withholding rates as ordinary dividends (30% or a lower tax treaty rate).

⁷ For a discussion of various tax law definitions of the term “substantially all,” *see* Cummings, “[How Much Is Enough Or Too Much?](#)” *Tax Notes* Feb. 29, 2016, pp. 1025, 1027.



The PATH Act included the most significant reform of FIRPTA since its enactment, including exempting QFPFs from FIRPTA. We acknowledge the Treasury Department as the originator of the idea to exempt QFPFs from FIRPTA in its Budget proposals.⁸ As appropriately described by the Treasury Department:

Gain of a U.S. pension fund from the disposition of a U.S. real property interest generally is exempt from U.S. tax, but gain of a similar pension fund created or organized outside the United States from the disposition of that same property would be subject to U.S. tax under FIRPTA.⁹

NAREIT respectfully requests guidance from the Treasury and IRS as to how certain of the PATH Act changes will be applied, and respectfully recommends basic actions that can be taken to ease the administrative obstacles for eligible non-U.S. persons investing in REITs and U.S. real estate.

1. Issue a revised Form W-8 that would: i) more efficiently permit eligible non-U.S. persons to claim exemption from FIRPTA withholding, including exemption from sales made by foreign pension plans; and, ii) allow pass-through entities to rely upon the non-U.S. person's certification of exempt status to prevent erroneous withholding at the pass-through entity level

Certain non-U.S. persons including QFPFs, described below, are now entirely exempt from tax under FIRPTA and its withholding regime. NAREIT requests that the IRS borrow from existing guidance and allow such eligible non-U.S. persons to certify their exemption from FIRPTA through a Form W-8.

The Code includes various withholding regimes in addition to FIRPTA that can apply to a non-U.S. person who is not otherwise exempt. The procedures for certifying exempt status depend on the withholding tax at issue, but generally follow a common approach—the non-U.S. person provides a variation of Form W-8. For example, non-U.S. persons may file a Form W-8 to claim exemption from the usual 30% withholding tax on investment income, or the Foreign Account Tax Compliance Act (FATCA). Eligible non-U.S. pension funds, for example, also can provide a Form W-8 to claim exemption from certain withholdings under tax treaties between the U.S. and their home countries. Yet, no variation of Form W-8 permits non-U.S. persons to claim exemption from FIRPTA, and pass-through entities such as domestic partnerships therefore cannot rely upon such a certification in determining the amount, if any, of FIRPTA tax to withhold.

⁸ See, e.g., Green Book at page 91.

⁹ *Id.*



Additionally, when a REIT makes a distribution to certain domestic partnerships, the initial distribution is not subject to withholding, but the corresponding income from the REIT to the partnership distributed or allocated by the partnership to non-U.S. partners could be subject to withholding regardless of whether those partners are exempt from FIRPTA. When all the partners are QFPFs, for example, those partners have no specified mechanism to certify their exemption to the partnership. Moreover, a foreign partnership arguably could provide certification to a REIT that it is exempt from FIRPTA if all of its partners are QFPFs. Even there, the uncertainty regarding whether a foreign partnership with multiple QFPF members qualifies as exempt could prevent such partnerships from certifying their exemption to the REIT, thus forcing the REIT to withhold amounts ultimately destined for exempt QFPFs.

While NAREIT appreciates the IRS and Treasury Department's issuance of [regulations](#) (and [corrected regulations](#)) under section 1445 that are designed to implement the QFPF exemption from FIRPTA pursuant to the PATH Act, NAREIT believes that a more effective approach would be for a QFPF to certify on a Form W-8 (or similar form) that it is a QFPF (rather than to certify that it is not a foreign person under the applicable regulations).

Accordingly, NAREIT requests that the IRS issue a revised Form W-8 that permits eligible non-U.S. persons to claim exemption from FIRPTA and allows pass-through entities to rely upon the non-U.S. person's certification of exempt status. In the context of partnership withholding under section 1446, this Form W-8 would allow both a U.S. and foreign partnership to determine the portion of its income allocable to a QFPF or other eligible foreign person that is not subject to FIRPTA withholding.

Many non-U.S. persons already complete Forms W-8 to claim exemption from other withholding taxes. NAREIT asks that the IRS leverage its existing procedures and provide non-U.S. persons a familiar means to certify their legal exemption from FIRPTA. However, if IRS and the Treasury Department would prefer not to issue a revised Form W-8 to certify FIRPTA exemption, NAREIT still requests that the IRS and the Treasury Department update the regulations under section 1446 in order to provide a mechanism for partnerships to certify the relevant exemptions from FIRPTA.



2. Clarify the treatment of USRPIs held, or distributions received from a REIT, by a QFPF

NAREIT requests guidance clarifying how the FIRPTA exemption afforded QFPFs applies to USRPIs held, or distributions received from a REIT, in the context of a QFPF investing through multiple tiers of entities.¹⁰

Section 323 of the PATH act added section 897(l)(1) to the Code, which provides that—

This section [*i.e.*, section 897] shall not apply to any United States real property interest held directly (or indirectly through 1 or more partnerships) by, or to any distribution received from a real estate investment trust by

(A) a qualified foreign pension fund, or

(B) any entity all of the interests of which are held by a qualified foreign pension fund.

Section 897(l)(3) provides that “the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection [*i.e.*, Section 897(l)].” Among other things, this provision exempts from FIRPTA the gain recognized by QFPFs on the sale of USRPIs (which would otherwise be subject to tax under section 897(a)) and distributions from a REIT attributable to the REIT’s disposition of USRPIs (which could otherwise be subject to tax under section 897(h)(1)) (Section 897(h)(1) Distributions). This exemption extends to “any entity all of the interests of which are held by a qualified foreign pension fund.”

a. *Clarify the treatment of indirect subsidiaries (other than fiscally transparent entities) of QFPFs.*

NAREIT requests guidance clarifying that an indirect subsidiary of a QFPF (other than fiscally transparent entities) is exempt from FIRPTA in the same way that a QFPF’s direct subsidiary is exempt. (In the case of a fiscally transparent entity, the QFPF itself is exempt on gain recognized through such entity, subject to the clarification regarding “Section 897(h)(1) Distributions” discussed below in Part c.) Under section 897(l)(1), for example, we think that the statutory language is clear that a wholly-owned direct corporate subsidiary of a QFPF would not be subject to tax under FIRPTA on the taxable sale of a USRPI. It is unclear, however, in the case of a QFPF invested in United States real property through a

¹⁰ Clarification of these issues previously were raised in a [comment letter](#) submitted on March 22, 2016, by Baker & MacKenzie. As further described herein, NAREIT agrees that clarification of the issues raised in that letter is necessary.



chain of two or more wholly-owned corporate subsidiaries, whether gain on the sale of USRPI by a lower tier subsidiary would be similarly exempt.

There does not appear to be any reason for excluding a lower-tier subsidiary of a QFPF from the section 897(l)(1) exemption. It could be argued, however, that because section 897(l)(1) does not explicitly apply to an entity all of the interests of which are held *directly or indirectly* by a QFPF, such indirect subsidiaries are not eligible for the exemption. The absence of “directly or indirectly” from section 897(l)(1)(B) is particularly notable because that phrase was included in section 897(l)(1) when referring to USRPIs “held directly (or indirectly through 1 or more partnerships)” by a QFPF.

There is no evidence that Congress intended to exclude lower-tier subsidiaries of QFPFs from the exemption of section 897(l)(1); the legislative history merely repeats the statutory language. Additionally, Joint Committee on Taxation’s technical explanation of the PATH Act (JCT Technical Explanation)¹¹, in describing conforming changes to section 1445 to eliminate withholding of FIRPTA tax on gains from the disposition of USRPIs by QFPFs, notes that the withholding exemption extends to “wholly-owned subsidiaries” of QFPFs.¹²

The Joint Committee’s gloss on the withholding exemption (which applies by cross reference to entities exempt under section 897(l)) makes no distinction between direct and indirect wholly-owned subsidiaries, and suggests that the Joint Committee understands Section 897(l)(1)(B) to apply equally to both.

Furthermore, similar language in regulations to other sections of the Code has been interpreted to include indirect subsidiaries. Treas. Reg. § 301.7701-2(b)(6) refers to business entities “wholly owned” by a State or foreign government, without specifying “indirect or direct” ownership. The Preamble to that regulation then clarifies that the regulation “is not limited to those entities directly owned by a State government.”¹³

NAREIT believes it would be contrary to the purpose of the PATH Act to subject QFPFs to FIRPTA tax simply because they invest in United States real property through a chain of more than one subsidiary.

b. *Clarify the treatment of entities owned by multiple QFPFs.*

Similarly, NAREIT requests guidance clarifying that an entity owned solely by multiple QFPFs is eligible for the QFPF exemption. Section 897(l)(1)(B) exempts “any entity all of the interests of which are held by a qualified foreign pension

¹¹ General Explanation of Tax Legislation Enacted in 2015, JCS-1-16, available at <https://www.jct.gov/publications.html?func=startdown&id=4874>.

¹² See p.283 of the JCT Technical Explanation.

¹³ 67. Fed. Reg. 49862-49864 (Aug. 1, 2002). Cf. Treas. Reg. § 1.892-2T(a)(3).



fund.” Although this language is ambiguous, it could be argued that this language exempts only entities the interests of which are held by a *single* QFPF. As with the treatment of indirect subsidiaries of QFPFs, however, there is no evidence that Congress intended to exclude entities owned entirely by two or more QFPFs, and NAREIT believes that it would run contrary to the purposes of the PATH Act to effectively subject QFPFs to FIRPTA simply because of the structure through which they invest in U.S. real estate, which structure may in some cases be required by non-U.S. law.

c. *Clarify the treatment of section 897(h)(1) Distributions received by QFPFs through fiscally transparent entities.*

NAREIT requests guidance clarifying the treatment of Section 897(h)(1) Distributions (*i.e.*, distributions made by a REIT attributable to the REIT’s sale of USRPIs) received by QFPFs through one or more partnerships. Section 897(l), added by Section 323 of the PATH Act, exempts “any distribution received from a real estate investment trust by—(A) a qualified foreign pension fund, or (B) any entity all of the interests of which are held by a qualified foreign pension fund.” While the PATH Act explicitly exempts investments in USRPIs “held directly (or indirectly through 1 or more partnerships),” it is unclear whether Section 897(h)(1) Distributions received “indirectly” are similarly exempt.

Furthermore, NAREIT believes it would be contrary to the purpose of the PATH Act to subject QFPFs to FIRPTA tax on Section 897(h)(1) Distributions merely because QFPFs invested in United States real property through partnerships. Like the statutory ambiguities discussed above with respect to indirect subsidiaries, such an interpretation would subject a QFPF to tax under FIRPTA simply because of the structure of the QFPFs’ investment in U.S. real property. NAREIT can see no rationale for distinguishing between QFPFs investing through partnerships and those investing directly, especially given that: 1) the PATH Act does not make this distinction with respect to gain recognized by a QFPF on the sale of USRPIs, and, 2) entities treated as partnerships for federal income tax purposes typically are the vehicle of choice for investments by pension plans in commercial real estate.¹⁴

Furthermore, the PATH Act does not generally distinguish between Section 897(h)(1) Distributions received directly or through partnerships in other contexts. Section 897(k), which exempts certain “qualified shareholders” from FIRPTA, applies equally to both gain from the sale of USRPIs and gain from the receipt of Section 897(h)(1) Distributions, whether recognized directly or through one or

¹⁴ *See, e.g.*, <https://www.reit.com/sites/default/files/media/PDFs/AssetAllocationandFundPerformanceVersion2.pdf> . *see also* [IRS Statistics of Income Partnership Returns, 2013](#) (showing real estate and rental and leasing accounted for almost 50% of all partnerships).



more partnerships. This suggests that Congress similarly did not intend disparate treatment for a QFPF investing through one or more partnerships for FIRPTA tax on Section 897(h)(1) Distributions and on gain from the sale of USRPIs.

3. Clarify the definition of QFPF

- a. *Confirm that QFPFs include foreign pension funds formed under the laws of foreign states and provinces.*

In order to be treated as a QFPF, an entity must be “created or organized under the law of a country other than the United States.” Foreign pension funds are often formed under the laws of particular states or provinces of foreign countries¹⁵ rather than under the laws of the countries themselves. (Similarly, most U.S. pension funds are formed under state, rather than federal, law.) NAREIT requests guidance confirming that foreign pensions funds formed under the laws of foreign states or provinces will be treated as “created or organized under the law of a country other than the United States” for purposes of section 897(l).

- b. *Clarify that foreign pension fund “arrangements” include structures with more than one separate entity.*

Section 897(l)(2) provides that in order to be treated as a QFPF, an entity must be a “trust, corporation, or other organization or arrangement” that satisfies various criteria, such as the provision of retirement or pension benefits. NAREIT requests regulations clarifying that “arrangement” encompasses certain alternative structures for organizing such entities. For example, in certain cases the foreign entity investing in U.S. real property may not be the same entity actually providing benefits to beneficiaries. Many foreign pension funds are formed as trusts. In those cases, the pension fund trustee may hold assets through a custodian trustee (or another nominee entity), which custodian trustee (or nominee entity) is not itself the pension fund trustee for the purposes of government regulation.

The JCT Technical Explanation notes that “[f]oreign pension funds may be structured in a variety of ways, and may comprise one or more separate entities. The word ‘arrangement’ encompasses such alternative structures.” NAREIT requests guidance reflecting the Joint Committee’s interpretation of Section 897(l)(2).¹⁶

¹⁵ See, e.g., the [Ontario Teachers’ Pension Plan](#), formed under the [laws of Ontario](#), one of the ten provinces of Canada.

¹⁶ See, e.g., the [“Agreement between the Government of Australia and the Government of the United States of America to Improve International Tax Compliance and to Implement FATCA,”](#) (US-Australia FATCA Agreement) which provides that “Australian Retirement Funds” are “exempt beneficial owners” for purposes of sections 1471 and 1472 of the Code (dealing with the



- c. *Clarify that Section 897(l)(2)(E)(i) is satisfied if contributions to a QFPF are deductible or excludable from the gross income of the contributor.*

In order for a pension fund to qualify as a QFPF, under the laws of the country in which the fund is established or operates, either i) contributions to the fund which would otherwise be subject to tax must be “*deductible or excluded from the gross income of such entity or taxed at a reduced rate,*” or ii) the investment income of the fund must be tax deferred or taxed at a reduced rate. NAREIT requests confirmation that an entity may qualify as a QFPF if contributions to the entity are deductible or excludable from the gross income of the fund’s contributing beneficiaries, rather than from the gross income of the QFPF.

- d. *Confirm that non-U.S. pension funds that provide benefits to self-employed individuals, their family members, and/or other non-employees can qualify as QFPFs exempt from FIRPTA.*

The definition of QFPF also requires that the non-U.S. pension fund is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or

Foreign Account Tax Compliance Act or FATCA). The US-Australia FATCA Agreement defines “Australian Retirement Fund” as:

1. Any plan, scheme, fund, trust, ***or other arrangement*** operated principally to administer or provide pension, retirement, superannuation, or death benefits that is a superannuation entity or public sector superannuation scheme (including an exempt public sector superannuation scheme) as defined in the Superannuation Industry (Supervision) Act 1993, or a constitutionally protected fund as defined in the Income Tax Assessment Act 1997.
2. A pooled superannuation trust as defined in the Income Tax Assessment Act 1997.
3. Any Entity that is wholly owned by, and conducts investment activities, accepts deposits from, or holds financial assets exclusively for or on behalf of, one or more plans, schemes, funds, trusts, ***or other arrangements*** referred to in subparagraphs (1) or (2) of this paragraph.

(Emphasis added).

The US-Australia FATCA Agreement thus contemplates that “Australian Retirement Funds” may be structured in any one of a number of ways, including as an “arrangement.” *See also* the corresponding provision in the “[Agreement between the Government of the United States of America and the Government of the Federative Republic of Brazil to Improve International Tax Compliance and to Implement FATCA](#)” (US-Brazil FATCA Agreement), treating as “exempt beneficial owners” certain Brazilian retirement plans. Pursuant to the US-Brazil FATCA Agreement, “a Brazilian retirement plan” includes “an Entity established or located in, and regulated by, Brazil, or a predetermined contractual **or legal arrangement**, operated to provide pension or retirement benefits or earn income for providing such benefits under the laws of Brazil and regulated with respect to contributions, distributions, reporting, sponsorship, and taxation.” (Emphasis added).



more employers in consideration for services rendered. The definition presumably is designed to include non-U.S. pension funds that provide benefits to self-employed persons including, for example, doctors, entrepreneurs and their families, just as Individual Retirement Accounts are considered retirement savings in the United States.

The JCT Technical Explanation appears to support this analysis:

Multi-employer and government-sponsored public pension funds that provide pension and pension-related benefits may satisfy this prong of the definition. For example, such pension funds may be established for one or more companies or professions, or for the general working public of a non-U.S. country.¹⁷

NAREIT requests further guidance confirming that plans like those described in the JCT Technical Explanation, including plans providing benefits to self-employed workers and their families, can qualify as QPPFs.

- e. *Confirm that non-U.S. pension funds administered by a governmental entity satisfy the requirement that they be subject to “government regulation.”*

Section 897(l)(2)(D) provides that a QPPF must be subject to government regulation. What constitutes “government regulation” is unclear, and commentators have suggested that it may have been “intended to grant benefits only to recognized pension funds that don't result in private inurement.”¹⁸ Notwithstanding this ambiguity, the requirement clearly requires that a QPPF is subject to some form of government oversight.

NAREIT requests guidance confirming that such oversight can include actual administration, control or creation of the pension fund by a governmental body, agency or entity.¹⁹ In other words, non-U.S. pension funds created, sponsored or

¹⁷ JCT Technical explanation, p.283, n. 968. Note that the U.S. Treasury has defined “pension benefits” in the context of FATCA as including “disability or death benefits” in its “Model Intergovernmental Agreement to Improve Tax Compliance and Implement FATCA, [Annex II](#),” November 4, 2013. In addition, for a number of U.S. government publications describing details regarding various social security systems (which include retirement, disability, and other benefits) throughout the world, see “[Social Security Programs throughout the World](#)” at the official U.S. Social Security Administration website.

¹⁸ Kim Blanchard, *New §897(l) Exempts Qualified Foreign Pension Funds from FIRPTA*, TAX MANAGEMENT INTERNATIONAL JOURNAL (March 11, 2016).

¹⁹ Again, the Ontario Teachers’ Pension Plan (OTPP) example is instructive. The OTPP’s 2015 [annual report](#) notes the following:



administered by a government should satisfy this QFPF requirement without the pension fund being required to prove that it is subject to a specific regime of government regulation.

- f. *Clarify what types of annual information reporting satisfies section 897(l)(2)(D).*

Another requirement in section 897(l)(2)(D) is that the QFPF must provide “annual information reporting about its beneficiaries” to the relevant tax authorities in the country in which it is established or operates. Pension funds in various countries have different information reporting requirements. NAREIT requests clarification on what “annual information reporting about its beneficiaries” must be provided to the relevant tax authorities.

For example, a registered pension scheme in the United Kingdom is required to submit the following information to Her Majesty’s Revenue & Customs (HMRC), which is the tax, payments and customs authority in the United Kingdom:

- i. an annual event report;²⁰
- ii. a registered pension scheme return, which may require information relating to, *inter alia*, contributions under the pension scheme and the membership of the scheme (the return is not provided annually but rather in the event that HMRC requires the return by notice);²¹
- iii. accounting for tax returns of the income tax to which the scheme administrator is liable, which are to be provided every three months;²²
- iv. notification of a winding up of the scheme;²³ and,
- v. monthly and annual payroll returns in relation to U.K. resident individuals in receipt of pension benefits.²⁴

Ontario Teachers’ Federation (OTF) and the **Ontario government** are the plan’s joint sponsors. Together, OTF and **the government** ensure the plan remains appropriately funded to pay pension benefits. **The sponsors jointly decide** the contribution rate paid by working teachers (and matched by the government and designated employers); the benefits that members will receive, including inflation protection; and how to address any funding shortfall or apply any surplus.

(Emphasis added).

²⁰ The reportable events in respect of the members are set out in the table included in Regulation 3 of the Registered Pension Schemes (Provision of Information) Regulations 2006/567.

²¹ See 250 FA 2004.

²² See 254 FA 2004.

²³ Regulation 4 of the Registered Pension Schemes (Provision of Information) Regulations 2006/567.

²⁴ See Income Tax (PAYE) Regulations 2003.



The information reporting required for a U.K. pension scheme should satisfy the annual information reporting requirement in section 897(l)(2)(D), but it is not entirely clear because: 1) some of reports are required on an annual basis only if certain events occur; 2) some of the reports are not required to be provided annually, but only if HMRC requires the report by notice; 3) some of the reports are required to be provided every three months, rather than annually; and, 4) some of the reports are not required for all beneficiaries.

NAREIT requests guidance on what satisfies the annual information reporting requirement in section 897(l)(2)(D). In the example described above, we would expect that the information reporting required for a U.K. registered pension scheme should satisfy that requirement.

g. *Provide guidance regarding the extent of a QFPF's activities that must be devoted to providing benefits.*

NAREIT also requests guidance regarding the requirement that a QFPF is established to provide retirement or pension benefits. Specifically, it is unclear whether there is a threshold amount of the QFPF's activities that must be devoted to providing benefits. For example, is the QFPF required to be "primarily" or "principally" focused on providing retirement and pension benefits? Perhaps a "substantially all" standard would be the most appropriate (*e.g.*, the standard applicable to C reorganizations under section 368, thus requiring, for example, that that at least 70% of a QFPF's activities be attributable to providing retirement or pension benefits).²⁵

However, NAREIT believes that any reasonable standard would be helpful in providing needed clarity. If so, NAREIT also requests guidance about how a non-U.S. pension fund can determine its eligibility under this prong of the QFPF definition so that the addition of a threshold concept does not further complicate the determination of QFPF status. For example, a non-U.S. fund similar to the U.S. social security system should not be disqualified because it also manages investments for other government regulated social insurance plans that are not strictly retirement related (*e.g.*, disability, workers compensation, and parental leave).²⁶

4. Clarify the definition of "Predecessor" for purposes of the FIRPTA Cleansing Exception

Gain from the sale of the stock of a USRPHC is generally subject to tax under FIRPTA. Under the FIRPTA "cleansing exception," however, a corporation that would be a USRPHC will immediately cease to be a USRPHC if: i) at the time the

²⁵ For a discussion of various tax law definitions of the term "substantially all," *see* Cummings, "[How Much Is Enough Or Too Much?](#)" *Tax Notes* Feb. 29, 2016, pp. 1025, 1027.

²⁶ *Cf.* Treas. Reg. § 1.892-2T(c)(1)(iii).



stock of the corporation is disposed the corporation owns no USRPIs; ii) any USRPIs the corporation held “directly or indirectly” during the 5-year period preceding the sale of its stock are “directly or indirectly disposed of in transactions in which the full amount of the gain was recognized;” and; iii) neither the corporation nor its “predecessor” was a REIT or RIC at any time during the 5-year period preceding the disposition of its stock. This third requirement was added to section 897(c)(1)(B) by the PATH Act. NAREIT requests clarification of the meaning of “predecessor.”

Nothing in the legislative history or supporting materials defines “predecessor” for purposes of the FIRPTA cleansing exception, and predecessor does not have a universal meaning across Code Sections. Most commonly, a “predecessor” corporation is one which has transferred assets to its “successor” in a transaction either to which Section 381(a) applies (*i.e.*, in a tax-free corporate liquidation or a tax-free reorganization) or, more broadly, in which the successor’s basis in the transferred assets is determined in whole or in part with reference to the predecessor’s basis in such assets (*i.e.*, “carryover basis” transactions).²⁷ In other contexts, however, such as in determining whether a REIT is a successor to another REIT that revoked or terminated its REIT election, a corporation is a “successor” to another corporation if it has sufficient overlap in ownership and assets, regardless of whether those assets were acquired in taxable transactions.²⁸

The lack of clarity over the meaning of “predecessor” could severely hamper the ability of a REIT to sell assets in taxable transactions, among other things. For example, a non-REIT C corporation (C corporation) might be hesitant to purchase assets from a REIT if holding the REIT’s former assets could cause the C corporation to be treated as having a REIT as a predecessor. In that case, the C corporation would be precluded from taking advantage of the cleansing exception for five years.

NAREIT requests guidance clarifying this ambiguity in the statute. Furthermore, NAREIT believes that it would be appropriate to define “predecessor” with reference either to section 381(a) or carryover basis transactions. If “predecessor” is defined to include REITs that have sold assets to C corporations in taxable transactions, REITs would be placed in a significant disadvantage relative to non-

²⁷ See, *e.g.*, Prop. Treas. Reg. § 1.163(j)-6(c)(2), Prop. Treas. Reg. § 1.172(h)-1(b)(2), Prop. Treas. Reg. § 1.355-8(b)(2) and -8(c)(1), Treas. Reg. § 1.382-2(a)(5), Treas. Reg. § 1.1374-10(a), Treas. Reg. § 1.1502-1(f)(4), and Treas. Reg. § 1.6655-4(a) (“predecessor” and “successor” defined with reference to Section 381(a) transactions); Treas. Reg. § 1.851-6(d), Treas. Reg. § 1.851-6(d), and Treas. Reg. § 1.1502-33(h) (“predecessor” and “successor” defined with reference to carryover basis transactions); Treas. Reg. § 1.1502-35(d)(5) (“predecessor” and “successor” defined with reference to both Section 381(a) transactions and carryover basis transactions); and Treas. Reg. § 1.1275-6(g) (“predecessor” and “successor” defined with reference to a “nonrecognition transaction”).

²⁸ See section 856(g) and Treas. Reg. § 1.856-8(c)(2).



REIT sellers, because C corporation buyers from REITs will be locked out of the FIRPTA cleansing rule for five years, but C corporation buyers from other sellers will not. There is no evidence that Congress intended this result.

C. Spin-off Provisions

1. Confirm that section 355(h)(2)(A) should apply, and section 856(c)(8) should not apply, when the effective date of the REIT election or elections—that is, the first day the entity or entities are treated as a REIT—coincides with or precedes the date of the distribution under section 355

The PATH Act contained new rules limiting the availability of a REIT election for certain entities that have been spun-off in a tax-free section 355 transaction. However, the PATH Act generally preserved the ability of a REIT achieve a tax-free spin-off of another REIT or a taxable REIT subsidiary. In order to qualify for tax-free treatment, among other things, section 355(h)(2)(A) provides that the distributing and the controlled corporations must both be REITs “immediately” after the distribution.

As a practical matter, the manner in which a corporation makes a REIT election is to file an IRS Form 1120-REIT rather than a regular Form 1120 as its tax return.²⁹ The due date of the 1120-REIT is the 15th day of the 3rd month after the end of the REIT’s taxable year. Even though the form is filed after the end of the REIT’s taxable year, the REIT “election” is effective for the taxable year to which the return relates.

The JCT Technical Explanation³⁰ indicates Congress intended that “[a]s long as a REIT election for each corporation is effective immediately after the distribution, the elections may be made after that time.” NAREIT requests that IRS and Treasury provide guidance recognizing Congressional intent that a corporation satisfies the “immediately” requirement of section 355(h)(2)(A) when the REIT files its Form 1120-REIT in a timely manner.

* * * * *

All of the suggested projects above would fulfill the goals and objectives set forth in Notice 2016-26. First, resolution of these issues would resolve significant

²⁹ See [IRS 2015 Instructions for Form 1120-REIT](#), U.S. Income Tax for Real Estate Investment Trusts, at p. 2 (“A corporation, trust, or association that meets certain conditions . . . must file Form 1120-REIT if it elects to be treated as a REIT for the tax year (or has made that election for a prior tax year and the election has not been terminated or revoked)). That is, the election is made by figuring taxable income as a REIT on Form 1120-REIT.

³⁰ General Explanation of the Tax Legislation Enacted in 2015, Staff of the Joint Committee on Taxation, p. 264 note 896.



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issues relevant to the more than 1,000 entities that have elected REIT status and the tens of thousands of taxpayers who invest in REITs.

Second, the recommended guidance promotes sound tax administration.

Third, the recommended guidance can be drafted in a manner that will enable taxpayers to easily understand and apply the guidance.

Fourth, the recommended guidance involves regulations that are outmoded, ineffective, insufficient, or excessively burdensome and that should be modified, streamlined, expanded, or repealed.

Fifth, the Service can administer the recommended guidance on a uniform basis.

Sixth, the recommended guidance reduces controversy and lessens the burden on taxpayers or the Service.

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,



Tony M. Edwards
Executive Vice President and General Counsel

Attachment

Cc: The Honorable Mark J. Mazur
The Honorable William J. Wilkins
Thomas West, Esq.
Michael S. Novey, Esq.

Helen Hubbard, Esq.
David B. Silber, Esq.
Andrea Hoffenson, Esq.
Julanne Allen, Esq.



Rev. Proc. 2016-_____

1. Purpose

Pursuant to authority under § 562(e)(2) and § 856(g) of the Code, this revenue procedure sets forth a safe harbor under which dividends from a real estate investment trust (“REIT”) will not be treated as preferential dividends under § 562(c) of the Internal Revenue Code and will be treated as dividends for purposes of computing the dividends paid deduction.

2. Background

.01. Under § 857(a)(1), the REIT’s deduction for dividends paid generally must equal or exceed: (A) the sum of (i) 90 percent of the REIT taxable income for the taxable year (determined without regard to the deduction for dividends paid (as defined in § 561) and by excluding net capital gain); and (ii) 90 percent of the excess of the net income from foreclosure property over the tax imposed on such income; minus (B) any excess noncash income (as determined under § 857(c)).

.02. The amount of any distribution by a REIT is not considered as a “dividend” for purposes of computing the dividends paid deduction if it is treated as a “preferential dividend” under § 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.

.03. The Protecting Americans from Tax Hikes Act of 2015 (Pub. L. 114-113, Division Q), December 18, 2015 (“PATH Act”) amended § 562(c) to exempt 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, from the preferential dividend rule. For this purpose, publicly offered REITs include not only the parent REIT filing such reports with the SEC, but also its subsidiary REITs that are consolidated with it on such filed reports under generally accepted accounting principles. REITs that are not publicly offered are still subject to the preferential dividend rule of § 562(c) but Congress expressly provided the Secretary of the Treasury with authority in § 562(e)(2) to make exceptions or remedies.

.04. Under § 562(c)(1), a REIT dividend distribution is treated as a preferential distribution unless:

- (1) the distribution is pro rata,
- (2) the distribution is made with no preference to any share of stock as compared with other shares of the same class, and
- (3) if multiple classes of stock exist, the distribution is made with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference.

.05. The legislative history of the preferential dividend rule indicates that the rule was meant to prevent income shifting among shareholders of a personal holding company (as defined in § 542), which, by definition under § 542(a)(2), is closely held. *See* H.R. Rep. No. 1860, 75th Cong., 3d Sess. 23 (1938) (“No dividends-paid credit should be allowed in the case of a distribution not in conformity with the rights of shareholders generally inherent in their stockholdings, whether the preferential distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance. . . . The committee believes that no distribution which treats shareholders with substantial impartiality and in a manner consistent with their rights under their stock-holding interests, should be regarded as preferential by reason of minor difference in valuations of property distributed.”). Consistent with this legislative history, the IRS has decided that some *de minimis* and relatively minor differences in distributions to shareholders are not treated as preferential dividends. *See, e.g.,* Rev. Rul. 83-117, 1983-2 C.B. 98.

.06. A REIT, by definition under § 856(a)(6) (as governed by § 856(h)) cannot be closely held, and so concern about income shifting among shareholders is not operative to the same extent in the REIT context as it is in the context of a personal holding company (as defined in § 542).

.07. Under § 1.562-2(a) of the Income Tax Regulations, specific illustrations of preferential dividends are set forth as follows:

(1) A corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class.

(2) A corporation will not be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock.

.08. As a general matter, § 1.562-2(a) of the Income Tax Regulations provides that a preference exists if any rights to preference inherent in any class of stock are violated. The three Examples set forth in § 1.562-2(b) of the Income Tax Regulations reflect the focus of the preferential dividend concept on discrepancies in the treatment of different holders of the same class or financially advantaging holders of one class of stock to the detriment of holders of another class of stock. Particularly when inadvertent, errors that are *de minimis* should not constitute preferential dividends. *See Hanco Distributing, Inc. v. Commissioner*, 32 AFTR 2d 73-5485 (D. Utah 1973).

.09. When a preferential dividend is found to exist, the entire amount of the REIT’s dividend distribution that includes the preferential dividend is not entitled to the dividends paid deduction. However, this taint does not extend to the REIT’s prior or subsequent dividend distributions, in that prior or subsequent dividend distributions are tested separately to determine whether or not they are preferential. *See Henry Schwartz Corp. v. Commissioner*, 60 T.C. 728 (1973).

.10. The PATH Act also amended § 562(e) to provide the Secretary with authority to provide an appropriate remedy to cure the failure of a non-publicly offered REIT to comply with the preferential dividend requirements in lieu of not considering the distribution to be a dividend for purposes of computing the dividends-paid deduction. That is, Congress has indicated that denial of the dividends-paid deduction is a harsh and inappropriate penalty when the violation of the preferential dividend rule is inadvertent or is due to reasonable cause and not due to willful neglect. In addition, with respect to a *de minimis* violation, there may be no contravention of the preferential dividend rule in the first place and so in any event relief without penalty should be made available to taxpayers for a *de minimis* violation.

.11. Historically, § 856(g) has provided relief when a REIT termination results from a violation of the preferential dividend rule, provided that the violation was due to reasonable cause and not due to willful neglect, and provided further that the Secretary collected a \$50,000 penalty for each failure if, as, and when prescribed.

3. Scope

This revenue procedure applies to the situations listed below that are recognized as not constituting tax avoidance or other circumstances that the Congress intended to be considered as preferential dividends.

The following examples are illustrative of situations that the Service will not treat as involving preferential dividends as to REITs. The Service will supplement this list as it becomes aware of similar circumstances through private ruling letter requests, fact patterns that are the subject of closing agreements and other sources of information. The Service recognizes that the examples provided in this revenue procedure are not exhaustive. No inference is intended that REIT dividends that are not specifically described in this revenue procedure constitute preferential dividends.

.01. The REIT's charter requires that dividends on preferred stock be declared or declared and paid before any dividends are paid on common stock. However, the board of directors of the REIT declares and pays dividends on the preferred and common stock simultaneously. Alternatively, the REIT's charter provides that dividends with respect to a certain class of shares be paid on a specific date, and either: a) the dividend payments with respect to that class of shares are not all mailed, wired or otherwise transmitted on the correct day, but within several days of one another; or, b) the dividend payments with respect to that class of shares are not all mailed, wired or otherwise transmitted on the correct day, but as soon as the REIT realizes the error, the relevant dividend payments are mailed, wired or otherwise transmitted.

(1) In both situations, no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the preferred shares, as well as on the common shares, has been distributed, although not in strict accord with the charter provisions.

(2) In both situations, the only question is timing, and the value of any timing differential is considered to be *de minimis*.

(3) Thus, there is no preferential dividend paid by the REIT with respect to this dividend.

.02. The REIT's charter provides that dividends on all classes of preferred stock shall be paid semi-annually and before any dividends are paid on the common stock. However, the board of directors adopts a practice of making distributions to the holders of all classes of preferred stock annually and to the holders of all common stock on a monthly basis.

(1) In this situation, no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the preferred shares, as well as on the common shares, has been distributed, although not in strict accord with the charter provisions. Finally, each share in each class received the same dividend distribution at or about the same time.

(2) In this situation, the only question is timing, and the value of any timing differential is considered to be *de minimis*.

(3) Thus, there is no preferential dividend paid by the REIT with respect to this dividend.

.03 The REIT's charter provides the method by which distributions and other payments are to be made with respect to shares of its stock (*e.g.*, by check mailed to the holder of record). However, the REIT makes a dividend distribution or other required payment to one or more shareholders by a method not in strict conformity with the requirements of the charter. Alternatively, the REIT makes a payment to one or more shareholders in a combined payment (*e.g.*, accrued dividend plus redemption premium) that the charter requires to be made in one or more separate payments.

(1) In this situation, no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the stock has been paid, although not in strict compliance with the formal procedures for payment.

(2) In this situation, the only issue involves certain mechanical formalisms and *de minimis* errors.

(3) Thus, there is no preferential dividend paid by the REIT with regard to these dividends.

.04. The REIT's charter provides that dividends on all classes of preferred stock and all classes of common stock shall be authorized by the board of directors before payment. Although the board of directors fails to formally authorize such payments to be made, the REIT makes dividend distributions on the preferred stock in general accordance with the provisions of the charter. In addition, the board of directors from time to time authorized and the REIT made dividend payments on the common stock during the period when no formal authorizations were in place for the dividend distributions paid on the preferred stock. Some years later, the board of directors formally ratifies the dividend distributions that have been paid on the preferred stock.

(1) In this situation, no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the preferred stock has been paid, although not in strict compliance with the formal procedures for authorization.

(2) In this situation, the only issue involves certain mechanical formalisms and *de minimis* errors, and the errors are, as and when discovered, rectified to the extent practicable.

(3) Thus, there is no preferential dividend paid by the REIT with regard to these preferred and common dividends.

.05. The records of the REIT contain errors regarding share transfers or the identity of its shareholders, either because of internal record-keeping discrepancies or because the shareholders (or their agents or representatives) failed to furnish correct or updated information to the REIT on a timely basis. The REIT thus erroneously pays dividends to some persons who are not shareholders and fails to pay dividends to some other persons who are shareholders. As and when such errors are discovered, they are rectified to the extent practicable.

(1) In this situation, but for such errors, no share of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, but for such errors, the full amount of dividends distributable on the shares has been distributed.

(2) In this situation, such errors are *de minimis* and are, as and when discovered, rectified to the extent practicable.

(3) Thus, there is no preferential dividend paid by the REIT with respect to these dividends or with respect to any payment made to rectify the errors.

.06. The records of the REIT contain errors regarding the number of shares of one or more classes of stock that are outstanding because of internal record-keeping discrepancies. For example, this situation could occur if REIT employees vest in restricted stock on a certain date, but the REIT's agent is unable to update its records in time to make the correct dividend payment. The REIT thus erroneously fails to pay dividends to some persons who are shareholders. As and when such errors are discovered, they are rectified to the extent practicable.

(1) In this situation, but for such errors no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, but for such errors the full amount of dividends distributable on the shares has been distributed.

(2) In this situation, such errors are *de minimis* and are, as and when discovered, rectified to the extent practicable.

(3) Thus, there is no preferential dividend paid by the REIT with respect to these dividends or with respect to any payments made to rectify the errors.

.07. The REIT has made all distributions with respect to its classes of stock in general accordance with the terms governing the same, but such amounts distributed are rounded up, down or to the nearest whole cent in order to avoid making distributions that include a fraction of a cent.

(1) In this situation, some holders of stock may receive a dividend differential, due to such rounding.

(2) The rounding of a dividend up, down or to the nearest whole cent is *de minimis*.

(3) Thus, there is no preferential dividend paid by the REIT with respect to these dividends.

.08. The REIT's charter provides for classes A, B, and C of preferred stock, as well as for common stock. Dividends on the preferred stock are to be paid before dividends are paid on the common stock. The REIT erroneously fails to pay any dividends on class C preferred stock, although it pays dividends on the other classes of preferred and on the common. The total amount of dividends paid by the REIT is 95% or more of the amount which would have been paid had the REIT paid dividends on the common and on all classes of preferred. As soon as the error is discovered, the REIT pays the amounts that it should have paid on the class C preferred stock, plus (if the REIT so chooses) an amount in the nature of interest to compensate the class C preferred shareholders for the delay in paying their dividend.

(1) In this situation, the amount of the errors was *de minimis*, and the errors are, as and when discovered, rectified. Moreover, any additional amount in the nature of interest payable as compensation for delay in payment of the dividend is intended to treat all shareholders with substantial impartiality.

(2) Thus, there is no preferential dividend paid by the REIT with respect to the dividends which were paid on the class A and class B preferred stock and the common or with respect to the payments made to rectify the error with respect to the class C preferred stock.

.09. The REIT acquires outstanding shares of its stock by purchase at arms' length from certain of its shareholders. Depending on the circumstances of the selling shareholders of these shares, the purchases by the REIT will be treated either as dividends under § 301 or as distributions in redemption under § 302. In both cases, under § 562(b) a portion of the amounts paid by the REIT for the shares could constitute dividends for purposes of computing the dividends paid deduction.

(1) In this situation, only the shareholders who sold their shares to the REIT will be considered to have received dividends from the REIT.

(2) All purchases by the REIT were made at arms' length. Accordingly, all shareholders were treated with substantial impartiality.

(3) Whether or not a deduction for dividends paid is permissible under § 562(c) and § 1.562-2 of the Income Tax Regulations with respect to the REIT's redemption of its shares, the redemption will not cause any prior or subsequent distribution by the REIT to be tainted and

thus any prior or subsequent dividend distributions are tested separately to determine whether or not they are preferential.

.10. The REIT is an “eligible entity” under § 301.7701-3 of the Income Tax Regulations that has elected to be taxed as a corporation for federal income tax purposes. The REIT adopts a plan of liquidation for federal income tax purposes that it intends to be governed by §§ 331, 336, and 562(b)(1)(B). Pursuant to the REIT’s organic documents and in connection with the adopted plan of liquidation, the REIT calls its preferred stock for redemption, although there are some small irregularities, nonconformities and inadvertent errors or omissions in providing redemption notices and in the mechanics of paying redemption proceeds and any accrued and unpaid cumulative dividends. Following the redemption of the preferred stock and also pursuant to the adopted plan of liquidation, the common shareholders of the REIT elect to liquidate the REIT for federal income tax purposes by having it elect to be classified as a partnership or disregarded entity for federal income tax purposes, all in the manner contemplated by § 301.7701-3(g) of the Income Tax Regulations.

(1) In this situation, no share of stock and no class of stock has received (or is deemed to have received) more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the preferred shares, as well as on the common shares, has been distributed (or is deemed to have been distributed), although not in strict accord with the charter provisions. Finally, each share in each class received the same dividend distribution at or about the same time.

(2) In this situation, the only questions are one or more of defects in notice, method of payment and timing, and the value of any notice or payment defects and timing differential is considered to be *de minimis*.

(3) Thus, there is no preferential dividend paid by the REIT with respect to its actual or deemed distributions in connection with its plan of liquidation.

4. Procedure

Dividend distributions made by a REIT that satisfy the safe harbors of Section 3 of this revenue procedure (including combinations of one or more such safe harbors) will not be treated as a preferential dividend for purposes of § 562(c).

If a REIT discovers an inadvertent distribution that it believes could be considered a preferential dividend before being notified about that distribution by the Internal Revenue Service, the REIT may remedy that apparent preferential dividend by: 1) including in its next filed tax return a statement describing the inadvertent failure or the basis on which the failure was due to reasonable cause and not due to willful neglect, along with a certification under penalty of perjury by the person signing the return; 2) if appropriate, take action to reverse the preferential dividend; and, 3) paying a \$50,000 penalty to the Internal Revenue Service. If the same or a substantially similar failure has occurred with respect to multiple distributions before being identified as a preferential dividend rule violation, and the REIT’s self-reporting is made before the failures were discovered

by the IRS, then the REIT shall be considered to have had a single failure for purposes of exacting the \$50,000 self-remediation penalty.

October 7, 2016

Electronically filed at www.regulations.gov

CC:PA:LPD:PR (REG-134016-15)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20224

Re: Proposed Regulations under Section 355 Concerning Device and Active Trade or Business

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts[®] (NAREIT) appreciates the opportunity to offer comments regarding the proposed regulations entitled “Guidance under Section 355 Concerning Device and Active Trade or Business” (REG-134016-15) (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

NAREIT recommends that the IRS and Treasury Department modify the Proposed Regulations as follows.

First, NAREIT recommends amending the Proposed Regulations to revert to a “device” test based on “investment assets,” rather than the new categories of “Business Assets” and “Non-Business Assets.”

Second, NAREIT recommends that the IRS and Treasury Department modify the Proposed Regulations to exempt transactions described in section 355(h)(2)(A) of the Internal Revenue Code of 1986, as amended (relating to distributions of REITs by REITs), from the application of the heightened



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scrutiny of Prop. Treas. Reg. § 1.355-2(d)(2)(iv) and the *per se* rule of Prop. Treas. Reg. § 1.355-2(d)(5).¹

Third, NAREIT recommends that the IRS and Treasury Department expand the “Business Assets” test in the Proposed Regulations for purposes of the “device” test under section 355 to include real estate owned by a REIT (and certain of its affiliates), without regard to whether such real estate would otherwise qualify as used in an active trade or business of the REIT.

Finally, NAREIT recommends that the IRS and Treasury Department include an example in the final regulations to demonstrate the application of the “anti-abuse” rule of Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(E) (not taking into account a transaction or series of transactions undertaken with a principal purpose of affecting the Nonbusiness Asset Percentage). In particular, NAREIT requests that an example be included exempting from the Proposed Regulations’ anti-abuse rule the case in which a REIT begins, no later than one year before a distribution, to self-manage properties that had been externally managed.

DISCUSSION

A. Background

The Proposed Regulations would make significant changes to one of the factors to be taken into account in determining whether a distribution by a corporation of its subsidiary was used principally as a device within the meaning of section 355(a)(1)(B). Under the regulations currently in effect, the determination of whether a transaction was used principally as a device takes into account the nature, kind, amount and use of the assets of the distributing and the controlled corporations (and corporations controlled by them) immediately after the transaction.²

Moreover, the current regulations specify that the existence of assets that are not used in a trade or business that satisfies the requirements of section 355(b) is evidence of a device.³ For this purpose, assets that are not used in a trade or business that satisfy the requirements of section 355(b) include, but are not limited to, cash and other liquid assets that are not related to the reasonable needs of a business satisfying such section.⁴ The strength of the evidence of a device depends on all the facts and circumstances, including, but not limited to, the ratio for each corporation of the value of assets not used in a trade or business that satisfy the requirements of section 355(b) to the value of its business that satisfies such requirements.⁵ A difference in the ratio described in the preceding sentence for the distributing and controlled corporation is ordinarily not evidence of device if the distribution is not *pro rata* among the shareholders of the

¹ Unless otherwise provided, all references to “section” in this letter shall be to the Code.
² Treas. Reg. § 1.355-2(d)(2)(iv)(A).
³ Treas. Reg. § 1.355-2(d)(2)(iv)(B).
⁴ *Id.*
⁵ *Id.*



distributing corporation and such difference is attributable to a need to equalize the value of the stock distributed and the value of the stock or securities exchanged by the distributees.⁶

The Proposed Regulations would introduce a distinction between “Business Assets” and “Nonbusiness Assets,” with the former defined as gross assets used in one or more “Businesses,” including cash and cash equivalents held as a reasonable amount of working capital for one or more “Businesses.”⁷ A “Business,” in turn, would be defined as an active trade or business, within the meaning of section 355(b) and Treas. Reg. § 1.355-3, without regard to, *inter alia*, the requirements relating to the active conduct throughout the five-year period preceding a distribution and acquisitions during such period (an ATB).⁸

In other words, any assets that qualify as used in an active trade or business, within the meaning of section 355(b) and Treas. Reg. § 1.355-3, regardless of the period during which such trade or business has been conducted, would be considered Business Assets under the Proposed Regulations. Nonbusiness Assets would be a corporation’s gross assets other than its Business Assets.⁹ The Proposed Regulations would require taxpayers to determine the amount of Business Assets and Nonbusiness Assets owned or deemed owned by the distributing corporation and the controlled corporation and to compare their relative “Nonbusiness Asset Percentages” with each other and would specify under what circumstances such ownership and such percentage are considered to be evidence of a device.¹⁰ In addition, in certain cases involving the separation of Business Assets from Nonbusiness Assets, a transaction would be considered to have been used principally as a device.¹¹

The requirement to distinguish between Business Assets and Nonbusiness Assets differs from the approach that the Treasury Department and the IRS had set forth in Rev. Proc. 2015-43.¹² In Rev. Proc. 2015-43, certain of the rules of the Proposed Regulations were foreshadowed. That prior guidance had focused on investment assets (using a modified section 355(g) definition)¹³ of a corporation as assets that may raise device concerns.

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Id.

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Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(B)(2).

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Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(B)(1).

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Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(B)(3).

¹⁰

Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(C).

¹¹

Prop. Treas. Reg. § 1.355-2(d)(5).

¹²

(2015-40 I.R.B. 467) (now incorporated into Rev. Proc. 2016-3 (2016-1 I.R.B. 126)) and Notice 2015-59 (2015-40 I.R.B. 459).

¹³

For purposes of Rev. Proc. 2016-3, “investment assets” has the meaning given such term by section 355(g)(2)(B), except as follows: (i) in the case of stock or securities in a corporation any stock of which is traded on (or subject to the rules of) an established financial market within the meaning of Treas. Reg. § 1.1092(d)-1(b) (publicly traded stock), Treas. Reg. § 1.355(g)(2)(B)(iv) is applied by substituting “50-percent” for “20-percent;” (ii) except as provided in clause (iv) of this sentence, an interest in a publicly traded partnership (as defined in section 7704(b), regardless of whether such partnership is treated as a corporation pursuant to section 7704(a)) is treated in the same manner as publicly traded stock; (iii) except as provided in clause (iv) of this sentence, an interest in a partnership that is not a publicly traded partnership is treated in the same manner as stock which is not publicly traded stock; and (iv) in the case of an interest in a partnership (other than a publicly traded partnership treated as a corporation pursuant to



However, in the preamble to the Proposed Regulations, the Treasury Department and the IRS announced that, after further study, the Treasury Department and the IRS had determined that investment assets as defined in such prior guidance “may include certain assets that do not raise device concerns, such as cash needed by a corporation for working capital, and may not include other assets that do raise device concerns, such as real estate not related to the taxpayer’s Business.”¹⁴ The Treasury Department and the IRS then stated that they had determined that “focusing on Nonbusiness Assets, as defined in the proposed regulations, is a better method of evaluating device or nondevice as compared to using investment assets as described in Rev. Proc. 2016-3 and Notice 2015-59.”¹⁵

B. Recommendations

1. Revert to a Test Based on Investment Assets

In 2005, Congress enacted section 355(g) to address certain “cash-rich” split-offs. The provision was aimed at redemptions of a distributing corporation’s shareholders with a controlled corporation that was loaded with cash or other liquid assets. Section 355(g) defined the assets that raised concern as investment assets to include cash, stock or securities or other liquid financial instruments¹⁶ and drew a line at two-thirds or more of the fair market value of the assets of the relevant corporation.¹⁷

We believe that the Treasury Department and the IRS should, as they had done in Rev. Proc. 2015-43 (now incorporated into Rev. Proc. 2016-3) and Notice 2015-59, take into account cash, stock or securities or other liquid financial instruments in determining whether evidence of device exists.

Although section 355(g) is an independent requirement for section 355(a) treatment, the concerns animating its enactment are similar to those relevant to the “device” and ATB requirement in the Proposed Regulations. Drawing a distinction between Business Assets and Nonbusiness Assets under the device test overlaps substantially with the rules of section 355(g). NAREIT believes that two separate provisions addressing the same asset-based concerns that can potentially result in different outcomes should be avoided in the sound administration of the tax laws, as it is much clearer for taxpayers and more administrable for IRS examining agents to deal with concerns about the nature of the corporation’s assets under a single provision and a single test.

section 7704(a)), the active trade or business of which is taken into account by the distributing corporation or the controlled corporation for purposes of section 355(b), or would be taken into account without regard to the five-year requirement of section 355(b)(2)(B), clauses (ii) and (iii) of this sentence do not apply. Rev. Proc. 2016-3, § 5.01(5).

¹⁴ Guidance Under Section 355 Concerning Device and Active Trade or Business, 81 Fed. Reg. 46,004, 46,007 (July 15, 2016).

¹⁵ *Id.*

¹⁶ See section 355(g)(2)(B).

¹⁷ See section 355(g)(2)(A)(i).



We therefore think it appropriate to conform to the Congressional distinction between assets that raise concerns and those that do not. Rev. Proc. 2015-43 (now incorporated into Rev. Proc. 2016-3) and Notice 2015-59 adopted the approach that we recommend. Inventing entirely new categories of so-called Business Assets and Nonbusiness Assets has little statutory grounding (especially when such so-called Business Assets are not ATB assets), and could give the appearance of attempting to override the explicit and relatively recent Congressional guidance in section 355(g). In addition, as we discuss in more detail below, the Business Assets/Nonbusiness Assets distinction raises a number of practical issues, especially in the REIT context.

2. **Exempt Distributions Described in Section 355(h)(2)(A) from the Device Test-Aspects of the Proposed Regulations**

On December 18, 2015, the President signed into law the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), which was enacted as part of Pub. Law No. 114-113, the “Consolidated Appropriations Act, 2016. Section 311(a) and (b) of the PATH Act added to the Code sections 355(h) and 856(c)(8), respectively. Section 355(h)(1) of the Code provides that section 355 shall not apply to a distribution if either the distributing corporation or the controlled corporation is a REIT. Section 355(h)(2) provides exceptions permitting a REIT to distribute the stock of another REIT or of a TRS under certain conditions. Section 856(c)(8) provides that a corporation may not elect REIT status during the ten-year period following a section 355 distribution if such corporation was the distributing corporation or the controlled corporation in that distribution.

Thus, in general, in enacting section 355(h), Congress evidenced a concern about the tax-free separation of assets of a corporation not qualifying as a REIT into those assets that could be held by a REIT and those that could not be so held, but it also evidenced that the distributions described in section 355(h)(2) do not pose a particular concern. This is consistent with the original intent of Congress when enacting the regime relating to REITs, namely to provide for an investment vehicle taxed at a single level that is accessible to the general public to make investments in real estate.¹⁸

In addition, the policy concerns undergirding Rev. Proc. 2015-43 (now incorporated into Rev. Proc. 2016-3) or the Proposed Regulations, such as policing end-runs around the repeal of *General Utilities*, simply have no applicability to REITs, which are effectively entities generally taxed only at the shareholder level. Further, REITs already have to satisfy a highly detailed regime of requirements, not just those under section 856, for qualifying or continuing REIT status, but also under section 355(h), and the temporary and, if adopted in final form, proposed regulations under section 337(d), all of which already adequately enforce the protection of the tax base of C corporations. One of these requirements is that REITs generally must distribute, on an annual basis and in distributions qualifying for the dividends-paid deduction, at least 90% of their real estate investment trust taxable income for the taxable year (determined without regard to the deduction for dividends paid (as defined in section 561) and by excluding any net capital

¹⁸ See H.R. REP. NO. 2020, 86th Cong., 2d Sess. at 3–4, 6 (1960).



gain). In fact, most SEC-registered REITs distribute at least 100% of their real estate investment trust taxable income for each taxable year.¹⁹ In light of this legal requirement and the practice adopted by most REITs, we believe that it is unlikely that distributions of REITs by REITs ordinarily raise significant device concerns, since it is unlikely that such distributions, followed by the sale of REIT shares, would have the effect of converting what would otherwise be ordinary dividend income into income taxed as capital gains.²⁰

For these reasons, we believe that the Treasury Department and the IRS should exempt the transactions described in section 355(h)(2)(A) (relating to distributions of REITs by REITs) from all the device aspects of these new Proposed Regulations (that is, the proposed amendments to Treas. Reg. § 1.355-2, including Prop. Treas. Reg. §§ 1.355-2(d)(2)(iv) and 1.355-2(d)(5), that would amend Treas. Reg. § 1.355-2). It should be noted that this proposal would not exempt REITs from the currently applicable ATB rules, the 5% ATB requirement in Prop. Treas. Reg. § 1.355-9 and the currently applicable device rules. Rather, it would exempt REITs from the heightened device and *General Utilities* requirements (including the *per se* rule of Prop. Treas. Reg. § 1.355-2(d)(5)) when the distribution already satisfies other applicable requirements (such as section 355(h) and section 337(d)). We believe, however, that given the special nature of REIT-to-REIT spin-offs, the application of the numerical tests of the Proposed Regulations (Prop. Treas. Reg. § 1.355-2(d)(2)(iv)) and, especially, the *per se* rule (Prop. Treas. Reg. § 1.355-2(d)(5)) are inappropriate to apply to such situations.

3. Expand the Definition of Business Assets

We believe that the limitation of Business Assets to those that would satisfy the ATB requirement but for the five-year period is unduly restrictive. In particular, many REITs could hold real estate assets that would, because of the special circumstances of the REIT industry and the real estate business, not qualify as an ATB but would nonetheless not pose any potential for abuse relating to the device-requirement.

By way of background, it is common that modern REITs are organized in so-called Umbrella Partnership REIT (UPREIT) structures in which a publicly traded REIT owns, as its sole significant asset, a significant (most often, majority) interest in a subsidiary partnership (called an Operating Partnership, or OP) that owns real property and manages and operates such property with its own employees. Unrelated partners own the remaining interests in the subsidiary partnership, usually as a result of having contributed property in exchange for such interests.²¹ In addition, it is worth noting that, because REITs must comply with detailed rules regarding the types and amounts of income they may earn, most REITs establish taxable REIT subsidiaries (TRSs) to earn income from activities otherwise not permitted to be earned by a REIT directly, such as for the performance of management services for properties owned by

¹⁹ See <https://www.reit.com/sites/default/files/1099/HistoricalDividendAllocationSummary.pdf>.

²⁰ See also Treas. Reg. § 1.355-2(d)(5)(ii).

²¹ See Treas. Reg. § 1.701-2(d), Example 4, in which the government concluded that these anti-abuse partnership regulations should not apply to the typical UPREIT transaction.



third parties or the performance of “non-customary” services to tenants of properties owned by the REIT.²² Independent contractors serve a similar role.²³

Example 1. A REIT conducts a real estate business through an OP that owns many real estate assets that are actively conducted by the OP. However, the OP also holds real estate assets that are managed by a TRS of the OP as well as real estate assets that are managed by independent contractors. Because such assets are managed by the TRS and independent contractors, they are not an ATB of the OP (or attributed to the REIT under Rev. Rul. 2007-42). If a partnership that owns these managed real estate assets not managed by the OP and the TRS were transferred to a controlled corporation and the controlled corporation was distributed by the REIT, such assets would not count as Business Assets.

Example 2. A REIT conducts a real estate business. In addition to its ATB of managing the construction and development of office buildings and actively renting out office space in the metropolitan area in which it is headquartered, it owns land and buildings that are currently net leased to third parties that do not constitute ATBs, the latter real estate being located in a new “frontier” metropolitan area that the REIT is entering. The REIT intends to redevelop the building opportunistically (as soon as the market permits) when the current net lease, which has three additional years to run, comes to an end, and such redevelopment efforts are integral to its business model. However, such an asset would not count as a Business Asset because it would not currently qualify as used in an ATB.

Example 3. A REIT conducts a real estate business. The REIT has traditionally focused exclusively on buildings providing only office space, and the REIT has an ATB of developing such buildings and actively renting and managing them. Because the REIT’s management believes that it would be prudent to diversify its holdings, the REIT has recently acquired high-end apartments. Since the REIT’s employees are not expert in managing such properties, the REIT has hired independent contractors to do so. Until the time at which the REIT will be able to attract employees to manage its apartments, such properties would not count as Business Assets.

Example 4. A lodging REIT owns hotels. Under the applicable REIT rules,²⁴ it must lease its hotels to a TRS,²⁵ and the TRS must engage an eligible independent contractor to operate the hotels. Although the REIT’s hotel business may not be considered as qualifying as an ATB

²² See section 856(d)(1)(B) and section 856(d)(2)(C).

²³ See section 856(d)(3).

²⁴ Income attributable to the extensive provision of maid services (and similar services provided to hotel guests) is not considered qualifying “rents from real property” for REIT purposes. See [Rev. Rul. 98-60](#) (detailed explanation). However, the REIT Modernization Act, Sections 541-71 of Pub. L. No. 106-70, the Ticket to Work and Work Incentives Improvement Act of 1999, specifically enacted provisions that allow hotel REITs to earn qualifying rent from hotel leases to their TRSs, provided that the TRSs engage an eligible independent contractor to manage and/or operate these hotels. Congress enacted similar rules for health care REITs in the REIT Investment Diversification and Improvement Act of 2008 (RIDEA), Pub. L. No. 110-289, §§ 3031-71.

²⁵ Section 856(d)(8)(B).



(because the hotels must be managed by third parties), hotels could be considered Business Assets.

We believe that the assets described in the examples above ought to be treated as Business Assets, consistent with the policies articulated in the proposed regulations. Unlike passive assets, they are not easy to value, usually not publicly traded and do not provide easy liquidity. Therefore, they do not present any potential for abuse. Instead, they are integral to the business of REITs. We therefore respectfully submit that the Business Assets test should be expanded to include real estate owned by a REIT, without regard to whether such real estate would otherwise qualify as used in an ATB of the REIT. To implement this proposal, the definition of Business Assets could be expanded to include assets which are “REIT-Connected Real Estate,” which could be defined as follows:

REIT-Connected Real Estate.—*REIT-Connected Real Estate* means real estate that is owned by a REIT or owned by a member of the qualified group of such REIT (within the meaning of Reg. § 1.368-1(d)(4)(ii), and taking into account the rules set forth in Treas. Reg. § 1.368-1(d)(4)(iii), but replacing the phrase “80 percent” with the phrase “50 percent” in each instance in which it occurs in section 368(c) when incorporating section 368(c) in the application of the rules set forth in Reg. §§ 1.368-1(d)(4)(ii) and 1.368-1(d)(4)(iii)).

We note that we do not believe that the types of real estate described in the examples above (and covered by the suggested definition of REIT-Connected Real Estate) should qualify as being used as part of an ATB under Treas. Reg. § 1.355-3²⁶ or Prop. Treas. Reg. § 1.355-9. Instead, we request that these types of real estate qualify as Business Assets for purposes of the device test in Treas. Reg. § 1.355-2(d) (and Prop. Treas. Reg. § 1.355-2(d)). This request follows especially in light of the newly proposed *per se* rule in Prop. Treas. Reg. § 1.355-2(d)(5), which would cause certain transactions involving the separation of Business Assets from Nonbusiness Assets to be considered to have been used principally as a device, notwithstanding the presence of nondevice factors or other facts and circumstances and subject to only limited exceptions.

4. **Provide an Example to Demonstrate the Application of the Anti-Abuse Rule in the Proposed Regulations**

In addition, we think that, given the definition of a Business, as described above (*i.e.*, an ATB without regard to the five-year requirement) and in light of the anti-abuse rule in Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(E), the Proposed Regulations could lead to uncertainty in scenarios in which Nonbusiness Assets would be converted into Business Assets in close temporal proximity to a distribution or otherwise in transactions related to a distribution (including in transactions entered into in anticipation of a distribution). For example, in Example 3 above, the REIT could begin to self-manage properties that were previously externally managed. We therefore request

²⁶ Thus, in order to meet the section 355 requirements, a REIT that owned, for example, undeveloped land still would need to satisfy, among other things, the requirement that such land be part of an ATB.



that the Treasury Department and the IRS include an example demonstrating that such a conversion, if occurring no later than one year before a distribution, would not be disregarded (under the anti-abuse rule or under other provisions of these Proposed Regulations) and that such assets, after such conversion, would be respected as Business Assets for purposes of Prop. Treas. Reg. § 1.355-2(d)(2).

We think that the time period of one year between the conversion and the distribution would be a sensible benchmark given the way in which such timeframe is considered in other analogous areas of the Code and the regulations. Thus, both section 338 and section 336(e) (and the regulations promulgated thereunder) require that, in order for an acquisition of stock to qualify as a “qualified stock purchase” or a “qualified stock disposition,” respectively, stock meeting the requirements of section 1504(a)(2) generally must be acquired during a twelve-month period.²⁷ Similarly, the regulations governing reorganizations within the meaning of section 368(a)(1)(B) provide as a guidepost that acquisitions of the target corporation is permitted to occur tax-free “in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months.”²⁸

We would be pleased to discuss these comments if you believe it would be helpful. Please feel free to 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,



Tony M. Edwards
Executive Vice President and General Counsel

The Honorable Jacob J. Lew
The Honorable Mark J. Mazur
The Honorable William J. Wilkins

Julanne Allen, Esq.
Stephanie D. Floyd, Esq.
Andrea Hoffenson, Esq.
Helen Hubbard, Esq.
Michael S. Novey, Esq.
William Paul, Esq.

²⁷ Section 338(d)(3), Treas. Reg. § 1.336(e)-1(b)(6).

²⁸ Treas. Reg. § 1.368-2(c).



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David B. Silber, Esq.
Russell P. Subin, Esq.
Krishna Vallabhaneni, Esq.
Robert H. Wellen, Esq.
Thomas West, Esq.



NAREIT Alert Important Industry Updates from NAREIT

Tax Report 2017-1 [Treas. Reg. § 1.337\(d\)-7](#) and [Temp. Treas. Reg. § 1.337\(d\)-7T](#)

Compendium References:

- 6.01 Distributions—Generally
- 7.03 - Taxation of REITs - Built in Gains
- 9.00 Reorganizations

On Jan. 17, 2017, the Treasury Department issued [final regulations](#) confirming that the built-in gain recognition period for REITs and regulated investment companies (RICs) is the same as that applicable to S corporations, *i.e.*, five years. If an S corporation (or REIT or RIC) disposes of former C corporation assets originally acquired as a result of conversion or in certain carryover basis transactions with built-in gain (BIG) during the BIG recognition period, it is liable for an entity-level tax on the BIG.

By way of background, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), enacted on Dec. 18, 2015, generally prevents tax-free spin-offs of REITs by C corporations after Dec. 7, 2015. However, the PATH Act allows REITs to spin off other REITs and taxable REIT subsidiaries (TRSs) held for at least three years on a tax-free basis. In addition, the PATH Act grandfathered companies from the spin-off rule if they had a pending IRS ruling request on Dec. 7, 2015. Separately, effective for taxable years beginning after Dec. 31, 2014, the PATH Act reduced the BIG recognition period to five years. Because the REIT built-in gain period is based upon the S corporation BIG period, the REIT BIG period also was reduced to five years.

On June 8, 2016, the IRS issued [final and temporary regulations](#) and [proposed regulations](#) (collectively, the Regulations). Effective for sales of former C corporation BIG property acquired by a REIT after Aug. 8, 2016, the Regulations imposed a 10-year BIG period for REITs (REIT conversions or acquisitions by REITs of C corporation BIG property prior to Aug. 8, 2016 remained subject to the 5-year PATH Act rule). Additionally, the Regulations imposed corporate-level tax on any BIG of a C corporation that is acquired by, or makes an election to be, a REIT (generally, a conversion transaction) during the twenty-year period beginning on the date that is ten years before the date of a section 355 spin-off (the Automatic Deemed Sale Rule).

Pursuant to a [correction](#) issued on June 28, 2016, the latter provision will apply only to spin-offs completed after Dec. 7, 2015. The Regulations contain exceptions consistent with the PATH Act regarding distributions by REITs of other REITs, TRSs, and with regard to companies that had a pending ruling request on Dec. 7, 2015.

On July 19, 2016, NAREIT submitted [comments](#) in response to the Regulations. Further, on Oct. 18, 2016, the Chairmen and the Ranking Members of the House Ways & Means and Senate Finance Committee sent a [letter](#) to then Treasury Secretary Lew that stated their belief that Congress intended that REITs and RICs use the same 5-year BIG recognition period as S corporations, and they asked the Treasury Department to amend the regulations to reflect such legislative intent. Tony Edwards of NAREIT also testified at the Nov. 9, 2016 Treasury and IRS hearing on the Regulations.

The final regulations issued Jan. 17, 2017 provide that the term "recognition period" means the recognition period described in section 1374(d)(7) (that is, a 5-year period), beginning on the first day of a REIT or RIC's taxable year (in the case of a REIT/RIC election) and, in the case of other conversion transactions, on the day the RIC or the REIT acquires the property. Although the final regulations will apply prospectively to conversion transactions after Feb. 17, 2017, taxpayers may choose to apply the 5-year recognition period, instead of the 10-year recognition period in the temporary regulations, to conversion transactions occurring on or after Aug. 8, 2016, and on or before Feb. 17, 2017.

Additionally, the Jan. 17 final regulations are narrowly focused on the REIT/RIC recognition period and do not address the Automatic Deemed Sale Rule. The preamble to these regulations states that "[t]he Treasury Department and the IRS continue to study the other issues addressed in the temporary regulations and the proposed regulations, including other issues raised by the comment, and welcome further comment on those issues."

On Jan. 20, 2017, the White House released [a memorandum](#) ordering a freeze on regulatory actions. Among other actions, the memorandum orders agencies to temporarily postpone for 60 days the effective date of regulations that have been published in the Federal Register but are not yet effective." Although these final regulations are effective for transactions occurring after the publication Jan. 20 memorandum, the preamble to the regulations specifically states "[t]hese regulations are effective January 18, 2017." The effect of the Administration's Jan. 20 memorandum on these regulations is not yet clear.

Contact

For further information, please contact NAREIT's Senior Vice President & Tax Counsel, Dara Bernstein, at dbernstein@nareit.com.