NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 26, 2011

VIA E-MAIL [Notice.Comments@irscounsel.treas.gov]

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2011-39)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2011-39: 2011-2012 Guidance Priority List Recommendations

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity, pursuant to Notice 2011-39, 2011-20 I.R.B. 786, to offer our suggestions regarding regulatory guidance to be placed on the 2011-12 Guidance Priority List. 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.

We request that the Department of the Treasury and the Internal Revenue Service include in their 2011-12 Guidance Priority List the following five issues, listed in order of priority, with the first two items having the greatest priority:

1) reversing Notice 2007-55 regarding liquidating REIT distributions to non-U.S. investors;

2) clarifying certain regulatory provisions regarding the consequences to REITs to certain "distressed" debt, as discussed more fully in a letter dated February 3, 2011 from NAREIT to then-Secretary Mundaca and Commissioner Shulman;

3) clarifying that a REIT's investment in the shares of a money market fund constitutes an investment in a "cash item" for purposes of section 856(c)(4)(A), [1] consistent with an item in the 2009-10 Priority Guidance Plan and in accordance

[1] For purposes of this letter, "section" refers to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

with the recommendations in an April 22, 2009 letter from the American Bar Association Section of Taxation (ABA Tax Section); and

4) revising the regulations under section 337(d) concerning "built in gains" so that these regulations do not apply to exchanges of property from a C corporation to a REIT under section 1031 nor to transfers of property to a REIT from a corporation exempt from tax under section 501(a), consistent with an item in the 2008-09 and 2009-10 Priority Guidance Plans, and in accordance with recommendations in a May 1, 2008 submission by the ABA Tax Section.

The reasons for the priority given to the above issues are as follows. First, because Notice 2007-55's application extends beyond Congressional intent, provides inconsistent results for foreign shareholders and domestic shareholders engaging in similar transactions, and discourages the investment of foreign equity in the U.S. at a time when such capital is needed to assist in the economic recovery, it should be reversed. Second, because of the difficult economic climate, guidance regarding the consequences of distressed debt would help ensure that REITs can work out existing mortgage loans and participate in the market for distressed mortgage loans without jeopardizing their qualification as REITs for federal income tax purposes. The other issues would permit REITs to carry on their business with more certainty and consistent with Congressional intent.

DISCUSSION

I. Priority Guidance Plan Recommendations

A. <u>Reverse Notice 2007-55 to Treat REIT Liquidations and Redemptions as Sales/Exchanges of Stock</u>

Although not clear, for many years tax practitioners concluded that payments from a REIT made as part of its liquidation or redemption should be considered a sale of its stock (to which FIRPTA does not apply under several circumstances) rather than a capital gain distribution (to which FIRPTA does apply in several circumstances). The IRS issued a private letter ruling in 1990 concluding that liquidating distributions should be treated as a sale of stock, but that ruling was revoked in 2004. In 2007, the IRS issued Notice 2007-55 in which it concluded that liquidating distributions and redemptions should be treated as capital gain liquidations that are subject to FIRPTA if paid to foreign shareholders. An item relating to Notice 2007-55 was contained on the 2008-09 Priority Guidance Plan, although the exact parameters of that item were unclear.

As more fully presented in another comment letter by the American Bar Association Section on Taxation (Tax Section) dated June 10, 2008, NAREIT believes that Notice 2007-55 should be reversed except when "the existing provisions create a clear loophole, namely, a foreign controlled REIT that undergoes a liquidation, with the REIT deducting liquidating distributions under section 562(b) and the REIT's foreign shareholders relying on the 'cleansing exception' of section 897(c)(1)(B) to avoid FIRPTA tax." As a result, if a third party stock sale would be exempt under current law (for example, as in the case of sales of shares of a "domestically controlled REIT", which are not United States Real Property Interests, or USRPIs), then the tax treatment of a non-dividend distribution that gives rise to a constructive sale or exchange ought to be taxed the same way. NAREIT agrees with this specific recommendation of the Tax Section as well as the other recommendations contained in its June 10, 2008 comment letter.

B. **<u>Modify Revenue Procedure 2011-16 to Encourage Workouts of Distressed Debt</u>**

NAREIT appreciates the issuance of Revenue Procedure 2011-16 (the Revenue Procedure) concerning modifications and acquisitions of distressed debt, and, in particular, the valuable guidance with respect to distressed mortgage loans that REITs modify to avoid foreclosure. With that said, and as discussed more fully in a February 3, 2011 NAREIT letter to the IRS and Treasury Department, NAREIT requests that the Revenue Procedure concerning modifications and acquisitions of distressed debt be clarified and revised as follows.

1) The Revenue Procedure should be clarified so that a REIT will not be penalized when the value of the real property that secures a distressed mortgage loan later increases. This clarification would prevent a disproportionate amount of a distressed mortgage loan from being treated as a nonqualifying asset when the value of the real property securing the loan increases;

2) Consistent with NAREIT's previous submissions on this issue, the Revenue Procedure should be revised to include a safe harbor providing that, when a REIT acquires a mortgage loan with market discount, the REIT may use as the "amount of the loan," for purposes applying the applicable apportionment regulations, the REIT's highest adjusted tax basis in the mortgage loan during the taxable year. If the Service believes that a regulatory change is needed to make this change, then NAREIT strongly urges that such a project be immediately initiated and then swiftly completed; and

3) The Revenue Procedure should be modified to include a safe harbor pursuant to which the value of, and the interest income from, a mortgage loan would not be bifurcated into qualifying and nonqualifying portions for purposes of the 75% gross income test or the 75% asset test if substantially all of the property securing the loan constitutes real property, determined as of the date the REIT committed to originate or acquire the loan. Such a safe harbor would mitigate many of the REIT qualification issues faced by REITs investing in distressed mortgage loans, as a REIT would not have to bifurcate a distressed mortgage loan when the value of the non-real property securing the loan is insubstantial.

If the Revenue Procedure is not clarified and revised as discussed herein, REITs will be significantly limited in their ability to invest in distressed mortgage loans and mortgage-backed securities. As a result, there will be less liquidity in the market for those assets, and retail investors will have limited ability to participate in that market. NAREIT believes that a failure by the Service to clarify and revise the Revenue Procedure would undermine the government's efforts to address the continuing effects of the credit crisis on the mortgage market.

NAREIT has requested this guidance in order to clarify the treatment of distressed loans and to eliminate uncertainties that are particularly problematic for publicly traded REITs. Given the country's current economic crisis, issuance of this guidance would be particularly timely.

C. Money Market Funds as "Cash Items" Under Section 856(c)(4)(A)

Section 856(c)(4)(A) requires that at the close of each calendar quarter of the taxable year at least 75% of the value of a REIT's "total assets" consist of real estate assets; government securities; and cash and cash items (the 75% asset test). On April 22, 2009, the ABA Tax Section submitted comments to the Internal Revenue Service requesting that the Treasury Department and the Service promptly issue guidance clarifying that a REIT's investment in the shares of a money market mutual fund (money market fund) constitutes an investment in a "cash item" for purposes of section 856(c)(4)(A).

As the ABA Tax Section noted:

> [Money market funds] play a pivotal role in the day-to-day operations of many companies, including [REITs], when cash must be readily available to meet the needs of their business. Money market funds are an attractive alternative to interest-bearing checking accounts due to the convenience they provide, their competitive returns, and their regulatory safeguards that are intended to provide liquidity and minimal risk to principal. In light of these features common to money market funds, industry practice for financial personnel and the accounting rules such personnel rely upon generally treat money market funds as "cash items."

NAREIT agrees with the ABA Tax Section's recommendation, especially since the Administration has taken extraordinary steps to assure the stability of money market funds. An item relating to this issue was included in the 2010-11 Priority Guidance Plan.

D. Revising Final Regulations Under § 337(d) Relating to Conversion Transactions Involving Tax-Exempt Entities

NAREIT reiterates its request for a revision to the regulations under § 337(d) relating to conversions of entities from, and transfers of assets by, C corporations to REITs or regulated investment companies (RICs), in accordance with the May 1, 2008 submission by the ABA Tax Section. An item concerning these issues was contained in the 2008-09; 2009-10; and 2010-11 Guidance Priority Lists.

The regulations under § 337(d) implement Congress' directive as part of the repeal of the *General Utilities* doctrine in the Tax Reform Act of 1986 (the 1986 Act) to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments effected by the 1986 Act, including:

> …regulations to ensure that such purposes may not be circumvented through the use of … a regulated investment company, real estate investment trust, or tax exempt entity…

Section 337(d).

Prior to its repeal, the *General Utilities* doctrine allowed certain transfers of appreciated property to avoid corporate level tax. The 1986 Act eliminated those rules, effectively preventing the avoidance of corporate-level tax on the disposition of appreciated property.

We support the suggestions made in those comments, and respectfully request that the IRS and Treasury Department revise the regulations under § 337(d) relating to conversions of entities from, and transfers of assets by, C corporations to REITs or RICs, in accordance with those comments.

The ABA Tax Section comments address two specific issues:

First, the ABA Tax Section points out that the § 337(d) regulations technically apply to transfers from a C corporation to a REIT or RIC in an "exchanged basis" transaction and indicates that this treatment is inappropriate. "Exchanged basis" transactions include § 1031 like-kind exchange transactions. C corporations often transfer real property in like-kind exchange transactions when a REIT is the acquirer. These transactions are commonplace, non-abusive, and do not implicate any of the concerns that are properly addressed by the regulations.

Second, the ABA Tax Section states that the § 337(d) regulations improperly treat tax-exempt corporations as "C corporations" for purposes of the regulations. It follows from this treatment that a transfer of assets from a tax-exempt corporation to a REIT or RIC can result in the imposition of a C corporation level tax with respect to the property (under § 1374 principles if the property is sold by the REIT or RIC within ten years). As the ABA Tax Section points out, this treatment also applies in connection with a transfer of assets from a real estate partnership to a REIT when the partnership has partners that are tax-exempt corporations. Such transfers are undertaken all the time, and for the reasons given by the ABA Tax Section, NAREIT believes that the regulations should not be applied in these situations.

II. Additional Comment: Expand and Enact Obama Administration Budget Proposal to Repeal Preferential Dividend Rule

There are situations in which a REIT inadvertently, through a "foot fault" such as a rounding error or similar situation, arguably could be viewed as having distributed a non-deductible, preferential dividend. Because these errors truly have no substantive meaning, we were pleased to see the Obama Administration's Fiscal Year 2012 budget proposal would repeal this rule for publicly traded REITs and provide authority for the Treasury Department to issue guidance dealing with inadvertent errors in situations in which the preferential dividend rule still applied. This proposal is consistent with an item on the 2007-08 and 2008-09 Priority Guidance Plans addressing the "correction of minor errors by RICs and REITs."

Over the past few years, NAREIT and the trade association for mutual funds, the Investment Company Institute, have had a continuing dialogue with personnel from the Treasury Department, the IRS' Financial Institutions & Products group, and the IRS' Large and Mid-Size Businesses division regarding a mutually acceptable resolution to this difficult issue. Last year, Congress enacted the RIC Modernization Act, which repealed the rule for ñpublicly offeredò regulated investment companies.

Although we support the Obama Administrationõs FY 2012 budget proposal which would repeal the preferential dividend rule for publicly traded REITs, we believe that it should be extended to all publicly offered REITs (just as the RIC Modernization Act extended the repeal to publicly offered RICs) as well. We look forward to working with the Treasury Department and IRS to obtain a legislative solution to this problem.

****

All of the suggested projects above would fulfill the goals and objectives set forth in Notice 2011-39. First, resolution of these issues would resolve significant 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, these projects would promote sound tax administration. Specifically, in the context of how to manage distressed debt, the requested guidance could relieve uncertainties that are potentially paralyzing.

Third, these projects could clearly be drafted in a manner that would enable taxpayers to easily understand and apply the guidance. We have been working with, and would be pleased to continue to work with, with the IRS in discussing both how the distressed debt guidance and how preferential dividend guidance could be drafted so as to apply to the most common types of non-consequential ñfoot faultsò (in cases in which the repeal of the rule would not be applicable).

Fourth, we believe that guidance under these projects easily could be administered on a uniform basis.

Finally, guidance on the requested projects would reduce controversy and lessen the burden on taxpayers or the Service for the reasons stated above.

Feel free to contact me or Dara Bernstein, NAREITõs Senior Tax Counsel, if you would like to discuss this issues in greater detail.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

cc: Mark J. Mazur, Esq.
Emily McMahon, Esq.
Douglas Shulman, Esq.

Jeffrey Van Hove, Esq.
Michael S. Novey, Esq.
Clarissa C. Potter, Esq.
Stephen R. Larson, Esq.