NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

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Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Entity Classification Proposals Would Impede Immediate Taxation of Foreign-Earned Income by U.S. REITs and Cause Potential Disqualification Issues

Dear Ms. Corwin:

On behalf of the National Association of Real Estate Investment Trusts (NAREIT), I am submitting this letter to highlight a number of potentially harmful and, we suspect, unintended consequences that the Obama Administration's Fiscal Year (FY) 2010 revenue proposals relating to the current "check the box" (CTB) regulations would have regarding real estate investment trusts (REITs). We respectfully request that you take the concerns expressed below under serious consideration as you develop the Administration's FY 2011 budget plan.

Specifically, we believe the CTB proposal as described in the Treasury Department's "Green Book" would put in jeopardy the REIT status of REITs that have invested overseas through foreign disregarded entities. While the proposal apparently is intended to address the use of the CTB regulations by U.S.-owned companies to achieve deferral of foreign earnings in cases in which such deferral may have not been intended, as noted below, the current entity classification regulations actually facilitate immediate U.S. taxation of foreign income relating to REITs. We thus request that the Entity Classification Proposal, if it is retained in the FY 2011 budget, be clarified so that it not apply in such instances.

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.

DISCUSSION

I. The Current CTB Regulations and Foreign Eligible Entities

Under the current CTB regulations, taxpayers can self-determine the classification for federal income tax purposes of domestic and foreign "eligible entities." [1] As relevant here, the CTB regulations allow a taxpayer to elect to treat its wholly-owned foreign eligible entity as a disregarded entity (DE) by filing an election form (referred to as "checking the box"). If such an election is made, transactions between the DE and its owner are ignored for U.S. tax purposes.

II. Entity Classification Proposal

Under the Entity Classification Proposal, many foreign disregarded entities would be converted to corporations for federal income tax purposes. The proposal would treat a foreign eligible entity as a disregarded entity only in two situations: 1) if the single owner of the foreign eligible entity is created or organized in, or under the law of, the foreign country in, or under the law of, which the foreign eligible entity is created or organized; and, 2) except in cases of U.S. tax avoidance, if the first-tier foreign eligible entity is wholly-owned by a United States person. The Entity Classification Proposal does not define "cases of U.S. tax avoidance."

The Green Book states the following as the reason for the Entity Classification Proposal:

> [a]s applied to foreign eligible entities, the entity classification rules may result in the unintended **avoidance** of **current** U.S. tax, particularly if a foreign eligible entity elects to be treated as a disregarded entity. In certain cases, locating a foreign disregarded entity under a centralized holding company (or partnership) may permit the migration of earnings to low-taxed jurisdictions without a current income inclusion of the amount of such earnings to a U.S. taxpayer under the Subpart F provisions of the Code.

(Emphasis added).

As further described below, REITs invest overseas through foreign disregarded entities to actually facilitate immediate U.S. tax on its foreign income, and to ensure compliance with the REIT tax rules. If not clarified with respect to REITs, the Entity Classification Proposal could thwart both of these goals and the Treasury's own goal of preventing unintended deferral.

[1] Treas. Reg. § 301.7701-3(b)(1)(ii) (domestic entities) and -3(b)(2)(i)(C) (foreign entities). Certain foreign entities are considered "per se" corporations and are ineligible for this election.

III. Investment by REITs in Foreign Disregarded Entities Facilitates Immediate U.S. Taxation of Overseas Income and Compliance with REIT Tax Rules

A. Background

First authorized by Congress in 1960,[2] REITs enable investors to own professionally managed, income-producing real estate by combining the capital of many shareholders to invest in a diversified portfolio of income-producing real estate. REITs must distribute at least 90% of their taxable income to their shareholders. In exchange for doing so (and for satisfying a number of other requirements designed to ensure they are real estate focused), federal law grants REITs a dividends paid deduction. Most REITs distribute close to or more than 100% of their taxable income; thus, REIT income essentially is taxed only at the shareholder level.

The existing CTB regulations allow REITs to meet these requirements. The regulations thus facilitate immediate taxation of REIT income from foreign investments as well as compliance with the REIT tax rules. Specifically, REITs may invest in foreign real estate[3] through a foreign limited liability entity that "checks the box" to be a DE. By doing so, the REIT achieves immediate and ongoing flow-through of foreign income that maximizes distributions to shareholders and complies with the REIT income and asset tests similar to its investment in U.S. real estate (described below). In many cases, once a top-tier CTB entity is established, regional investments (*e.g.*, the European Union or Asia) are made through subsidiary disregarded entities in order to achieve operational efficiencies, minimize liabilities, and reduce foreign taxes. Reduction in foreign taxes allows for a greater amount of income to flow through to REIT shareholders. As REITs generally do not claim foreign tax credits and cannot pass such credits through to shareholders, a reduction in foreign taxes results in REITs being able to distribute more income currently to shareholders. Under no circumstance is deferral of U.S. tax an intended result of this use of the CTB regulations.

B. Gross Income Rules

At least 75% of a U.S. REIT's annual gross income (75% Basket Income) must be from real estate-related sources, including rents from real property and interest on secured mortgages, and at least 95% of a U.S. REIT's annual gross income (95% Basket Income) must be from the 75% sources, as well as passive income, such as non-real estate interest and dividends. Thus, only 5% of a REIT's annual gross income (5% Basket Income) can be from non-real estate, non-passive sources without jeopardizing the REIT's status.

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[2] The REIT rules are contained in Subchapter M of the Internal Revenue Code of 1986, as amended (the Code). For purposes of this letter, "section" refers to a section of the Code, unless otherwise indicated.
[3] Rev. Rul. 74-191, 1974-1 C.B. 170 concluded that otherwise-qualifying assets do not fail to satisfy section 856(c)(4) merely because the assets are located outside the United States.

C. Asset Rules

Among other things: 1) at least 75% of the value of a REIT's total assets quarterly must be from "real estate" sources (including foreign real estate); 2) a REIT cannot own more than 10% of the vote or value in a corporation other than another REIT, a "taxable REIT subsidiary" (TRS) or a wholly-REIT-owned "qualified REIT subsidiary" (QRS)[4] (10% Asset Test); and, 3) the value of securities of all TRSs cannot amount to more than 25% of a REIT's assets (TRS Asset Test).

D. Enactment of the Entity Classification Proposal Would Impede Immediate Taxation of Foreign-Earned Income by REITs and Could Jeopardize REIT Status

If the Entity Classification Proposal were enacted, and a DE were treated as a corporation for U.S. tax purposes,[5] the REIT's tax status potentially would be jeopardized because the REIT would fail the 10% Asset Test (it would now own more than 10% of a "corporation"), unless TRS classification were elected. However, even if the entity were a TRS, it could fail the TRS Asset Test, thereby jeopardizing its REIT status, and potentially fail the 95% Basket Income Test. Because many REITs own and operate their properties through an operating partnership, a DE is not likely to be a QRS because it would be owned by the REIT's operating partnership, rather than the REIT.

Therefore, under the proposal, qualifying real estate income currently subject to immediate taxation in the United States would be converted to — at best — dividend income subject to taxation only when distributed. In the worst case, what had been a DE would be considered by the IRS to be a controlled foreign corporation (CFC), the income could be considered Subpart F income, and would thus potentially be categorized for REIT purposes as 5% Basket Income. Under current regulations, the concern regarding the characterization of Subpart F income as 5% Basket Income occurs because the IRS has not yet issued guidance on the character of such income under the REIT Income Tests. While there is legislative history requesting the Treasury Department to clarify that dividend-like Subpart F income is qualified 95% Basket Income,[6] that

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[4] Under section 856(i), a QRS is treated as a disregarded entity of its parent REIT.

[5] Although the Entity Classification Proposal would treat a first tier DE as a DE, that is only so absent "U.S. tax avoidance," which is not defined. As noted above, REITs may invest in several tiers of DEs that may be formed in different countries; thus, the second potential exception (relating to DEs in the same country) also would be inapplicable.

[6] The Housing and Economic Recovery Act of 2008 (the Act), Sections 3031-3071 of Pub. L. No. 110-289, includes several provisions the genesis of which was H.R. 1147 and S. 2002, the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA). Among other things, RIDEA authorizes the Treasury Department to classify any income item as either satisfying the REIT gross income tests or as being excluded from its computations. In describing this clarification of regulatory authority, Representative Joseph Crowley (D-NY) stated in his introductory remarks concerning RIDEA:

> Under current law, even if a REIT were to earn a substantial amount of certain types of income that are not specified in the gross income baskets, the REIT could jeopardize its REIT status—even though these types of income may be directly attributable to the REIT's business of owning and operating commercial real estate. …
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> Under this provision, I would expect that the IRS would conclude, for example, that dividend-like items of income such as Subpart F income and income produced by holding stock of a passive foreign investment

result still would convert qualifying real estate income that is passed through to shareholders to less attractive dividend income for no compelling reason.

IV. Entity Classification Proposal Should Not Apply to Situations In Which No Deferral Exists, Such As REIT Investments in Wholly-Owned Disregarded Foreign Entities

Although the Entity Classification Proposal appears to be concerned with the use of the CTB regulations to achieve deferral of U.S. tax when such deferral was never intended**,** nothing in the Proposal excludes factual situations in which no deferral exists**.** Yet, this would be the result in the case of a U.S. REIT's investment in a series of wholly-owned foreign disregarded entities. For example, although the Green Book states that the proposal would not apply to first tier foreign disregarded entities in the absence of U.S. tax avoidance, it is unclear whether the Proposal would exempt the first-tier disregarded foreign entity of a U.S. REIT because "U.S. tax avoidance" is not defined.

Furthermore, as noted above, there are situations in which a U.S. REIT might invest overseas through a string of disregarded entities in different countries, with the ultimate disregarded entity owning property in a particular country and leasing it to tenants for qualifying rental income. Under current law, this qualifying rental income is passed through to the U.S. REIT and distributed to shareholders. The Proposal would convert this income into dividend income, potentially treated as Subpart F income (or passive foreign investment company income), with respect to which there is no clarity on its treatment as qualifying REIT income.

Finally, we have been advised that the transition from DE to CFC/TRS status could be extremely detrimental to REITs because a deemed outbound transfer of assets would occur. Most likely the exceptions contained in section 367(a) would not be met, causing the outbound transfer to result in full recognition of the built-in gain in any real estate held in a foreign DE. Furthermore, most REITs rely on the method contained in 1991 proposed regulations for maintaining their section 987 pools, so that the deemed outbound transfer would result in a triggering of any built-in currency gain or loss inherent in their non-U.S. functional investments. Without any mechanism to address the potential tax impact of the deemed outbound transfer of assets, REITs could have a tremendous amount of non-cash income which could affect their ability to meet their distribution requirements.

Accordingly, we request that the Entity Classification Proposal, if included in the President's 2011 budget plan, be clarified and/or amended so that it would not apply to situations in which no deferral exists, such as investment by U.S. REITs in wholly-owned foreign disregarded

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> company either are considered qualified income for purposes of the REIT income tests [or] are not taken into account for purposes of these tests.

153 Cong. Rec. E384 (Daily Digest, Feb. 16, 2007) (Remarks of Rep. Joe Crowley (D-NY)) *See also* 153 Cong. Rec. S10931 (Daily Digest, Aug. 3, 2007). (Remarks of Sen. Orrin Hatch (R-UT)) (similar). NAREIT submitted a letter to the Treasury Department on Aug. 13, 2008 requesting the government immediately place on its priority list of regulatory business plan items a project under which it will issue guidance that Subpart F income or income from a passive foreign investment company (PFIC) is either qualified income under the 95% gross income test or is excluded from computing that test. To date, there has been no regulatory guidance on this issue.

entities. We also reiterate our earlier request that the Treasury Department clarify that dividend-like items of income such as Subpart F income and income produced by holding stock of a passive foreign investment company either are considered qualified income for purposes of the REIT income tests or are not taken into account for purposes of these tests.

Thank you for the opportunity to submit these comments.

Respectfully submitted,

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