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May 30, 2017

VIA ELECTRONIC SUBMISSION [www.regulations.gov]

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2017-28) Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2017-28: Request for Comments Regarding Recommendations for Items that Should be Included on the 2017-2018 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 2017-18 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

First, NAREIT reiterates the recommendations included in its October 7, 2016 comments regarding the proposed regulations under section 355[1] concerning device and active trade or business (REG-134016-15) (the Proposed ATB Regulations) to narrow the application of those regulations. If these suggested changes are not possible, NAREIT requests that the Treasury Department withdraw these regulations.

Second, NAREIT reiterates the recommendations included in its May 16, 2016 comment letter regarding Notice 2016-26 and the 2016-17 Priority Guidance Plan in connection with the tax-free distributions of the stock of one REIT by another REIT. Specifically, 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, generally prohibits tax-free distributions of REITs except in certain cases, such when both the distributing and controlled corporations are REITs "immediately" after the distribution. NAREIT requests that IRS and Treasury

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

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provide guidance recognizing Congressional intent that an electing REIT satisfies this "immediately" requirement when it files its REIT election Form 1120-REIT in a timely manner.

Third, NAREIT reiterates the recommendations included in its July 19, 2016 comments regarding the final, temporary (T.D. 9770) and proposed regulations (REG–126452–15) relating to certain transfers by C corporations of appreciated assets to regulated investment companies and REITs (the 2016 BIG Regulations).

Fourth, NAREIT again recommends withdrawal of Notice 2007-55 concerning the Foreign Investment in Real Property Tax Act (FIRPTA) consequences of liquidating REIT distributions to non-U.S. investors. NAREIT submitted written requests for withdrawal of Notice 2007-55 in 2012, 2011, and 2009.

We reiterate our request for the next nine items listed below that were included in NAREIT's submission on May 16, 2016 relating to Notice 2016-26 and concerning the 2016-17 Priority Guidance Plan, and largely relate to clarifications under the PATH Act.

The PATH Act included changes to the FIRPTA derived from H.R. 2128 and legislative provisions derived from the "Update and Streamline REIT Act" (H.R. 5746, introduced in 2012, the U.S. REIT Act);. The potential areas of regulatory guidance needed are set forth below under a separate heading for each of those items. With respect to these items, NAREIT believes that the qualified foreign pension fund (QFPF) and preferential dividend 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 2017-18 PGP the following ten items:

1) 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;

2) guidance regarding the treatment of USRPIs held, or distributions received from a REIT, by a QFPF;

3) guidance clarifying the definition of QFPF;

4) guidance clarifying the definition of "predecessor" for purposes of the FIRPTA Cleansing Exception (as defined below); and,

5) 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);

6) 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;

7) 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);

8) guidance regarding the determination of ancillary personal property for purposes of section 856(c)(9); and,

9) guidance clarifying the meaning of certain terms under sections 857(b)(6)(C)(v) and section 857(b)(6)(D)(v) (concerning the safe harbor exception to the tax on gains from prohibited transactions).

Finally, as NAREIT recommended in its March 23, 2016 letter in connection with inclusion of a guidance item defining "congregate care facility" for purposes of the definition of a "health care facility" under sections 856(e)(6)(D)(ii) and (l)(4)(B), on the Treasury Department and IRS' 2015-2016 Priority Guidance Plan, as well as in response to Notice 2016-26's request for comments on recommendations for the 2016-17 Priority Guidance Plan, NAREIT does not believe that additional guidance is needed or merits priority attention. Instead, NAREIT would prefer the IRS and Treasury Department to continue to issue guidance pursuant to the recommendations contained in this comment letter.

DISCUSSION

A. Spin-off Provisions

1. Proposed ATB Regulations Concerning Active Trade or Business Requirement

The Proposed ATB 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).

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."[2] 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).[3]

In other words, any assets that qualify as used in an ATB, 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.[4] 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.[5] 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.[6]

As stated in its October 7, 2016 comment letter regarding the Proposed ATB Regulations, NAREIT again respectfully recommends the following:

First, NAREIT recommends amending the Proposed ATB 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 ATB Regulations to exempt transactions described in section 355(h)(2)(A) (relating to distributions of REITs by REITs), from the application of the heightened 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).

Third, NAREIT recommends that the IRS and Treasury Department expand the "Business Assets" test in the Proposed ATB 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 ATB Regulations' anti-abuse

[2] Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(B)(2).
[3] Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(B)(1).
[4] Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(B)(3).
[5] Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(C).
[6] Prop. Treas. Reg. § 1.355-2(d)(5).

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.

If it is not possible to amend the Proposed ATB Regulations to incorporate the above recommendations, NAREIT recommends that the Treasury Department withdraw the Proposed ATB Regulations so that non-tax motivated transactions not be negatively impacted by excessive regulation .

2. 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.[7] 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 Explanation[8] 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.[9]

[7] See IRS 2016 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.
[8] General Explanation of the Tax Legislation Enacted in 2015, Staff of the Joint Committee on Taxation, p. 264 note 896.
[9] The requested guidance would be identical to the position already taken in Treas. Reg. § 1.337(d)-7T(f)(3)(i) (determining REIT status "immediately after" a section 355 distribution includes "(including by reason of elections under section 856(c)(1) made after the related section 355 distribution that are effective before the related section 355 distribution)".

B. Transfers of Appreciated Property by non-REIT C Corporations[10] to RICs and REITs

Among other things, the PATH Act made permanent the 5-year period for the recognition of gain under section 1374, which had been reduced from 10 years in previous years on a temporary basis.[11] Additionally, the previous final regulations under section 337(d) (the "2013 Regulations") generally provided that, when a REIT disposes of appreciated property after converting to a REIT from a C corporation or acquiring property from a C corporation (a Conversion Transaction), the REIT must apply the rules of section 1374 for a specified built-in gain recognition period (currently five years) and pay tax at the corporate level on any built-in gain except to the extent that the C corporation either recognizes gain on the transaction or elects "deemed sale" treatment to recognize and pay tax on the gain from the transaction. The PATH Act also generally eliminated the ability of non-REIT C corporations to participate in tax-free REIT spin-offs under section 355, either as a distributing corporation or a controlled corporation. The PATH Act further restricted REIT spin-offs by prohibiting a non-REIT C corporation that has engaged in a tax-free spin-off from electing to be a REIT within 10 years of the spin-off.

Although the 2016 BIG Regulations originally provided that the built-in gain (BIG) recognition period under section 1374 was 10 years for REITs, following notice and comment and a public hearing, the IRS appropriately modified the BIG period to five years to be consistent with Congressional intent[12].

Additionally, the 2016 Regulations generally require deemed sale treatment (with no ability to elect section 1374 treatment) for any C corporation that engages in a Conversion Transaction within 10 years of a tax-free spin-off that involves the converting C corporation (the Automatic Deemed Sale Rule).[13]

As stated in its July 19, 2016 comment letter regarding the BIG Regulations, NAREIT again respectfully recommends that the 2016 Regulations:

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

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[10] Although REITs are clearly C corporations, for the remainder of the letters the term "C corporation" will refer to non-REIT C corporations unless otherwise indicated.
[11] *See* section 1374(d)(7)(A).
[12] T.D. 9810, 82 Fed. Reg. 5387 (January 18, 2017).
[13] On June 27, 2016, the Treasury Department and the IRS issued a technical correction to the effective date of the 2016 Regulations, which correction clarifies that the regulations do not apply to spin-offs that occurred before December 7, 2015 (*i.e.*, before the effective date of the REIT spin-off rules contained in the PATH Act). This technical correction aligns the 2016 Regulations with the PATH Act and makes it clear that, as under the PATH Act, an entity that engaged in a tax-free spin-off before December 7, 2015, can convert to a REIT or be acquired by a REIT without being subject to immediate tax on all of the built-in gain in its assets. NAREIT appreciates the Treasury Department's and the IRS' quick correction.

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

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

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

If these changes are not adopted, NAREIT recommends that the Treasury Department withdraw the BIG regulations and start over again so that non-tax motivated transactions not be negatively impacted by excessive regulation.

C. <u>FIRPTA Provisions</u>

1. Reverse Notice 2007-55 to Treat REIT Liquidations and Redemptions as Sales/Exchanges of Stock

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).

As more fully presented in a comment letter by the American Bar Association Tax Section (the Tax Section) dated June 10, 2008, and as NAREIT has requested in in its 2012, 2011, and 2009 written submissions to the IRS and Treasury Department, NAREIT believes that Notice 2007-55 should be withdrawn..”[14]

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.

2. PATH Act Provisions

The PATH Act included the most significant reforms to 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.[15] 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.[16]

NAREIT respectfully renews its request for 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.

[14] NAREIT’s prior submissions stated that the withdrawal of Notice 2007-55 also should not apply if a REIT relies on the “cleansing exception” of section 897(c)(1)(B). However, this exception is no longer necessary because Congress clarified in the PATH Act that the cleansing exception does not apply to REITs and RICs.
[15] *See*, *e.g.*, Green Book at page 91.
[16] *Id*.

a. 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.

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.

b. 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.[17]

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."

i. *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

[17] 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.

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 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 one 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)[18], 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.[19]

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."[20]

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.

[18] General Explanation of Tax Legislation Enacted in 2015, JCS-1-16, available at https://www.jct.gov/publications.html?func=startdown&id=4874 .
[19] *See* p.283 of the JCT Technical Explanation.
[20] 67. Fed. Reg. 49862-49864 (Aug. 1, 2002). *Cf.* Treas. Reg. § 1.892-2T(a)(3).

ii. 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 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.

iii. *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.[21]

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 more partnerships. This suggests that Congress similarly did not intend

[21] *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).

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.

c. Clarify the definition of QFPF

i.. 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 countries22 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).

ii. *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).[23]

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[22] *See, e.g.,* the Ontario Teachers' Pension Plan, formed under the laws of Ontario, one of the ten provinces of Canada.

[23] *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 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.

iii. *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.

iv. 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 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

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> 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).

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.[24]

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 QFPFs.

v. *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 QFPF 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."[25] Notwithstanding this ambiguity, the requirement clearly requires that a QFPF 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.[26] In other words, non-U.S. pension funds created, sponsored or 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.

vi. *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

[24] 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.

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

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

> 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).

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;[27]

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);[28]

iii. accounting for tax returns of the income tax to which the scheme administrator is liable, which are to be provided every three months;[29]

iv. notification of a winding up of the scheme;[30] and,

v. monthly and annual payroll returns in relation to U.K. resident individuals in receipt of pension benefits.[31]

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.

vii. *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).[32]

[27] 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.
[28] See 250 FA 2004.
[29] *See* 254 FA 2004.
[30] Regulation 4 of the Registered Pension Schemes (Provision of Information) Regulations 2006/567.
[31] *See* Income Tax (PAYE) Regulations 2003.
[32] 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.

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).[33]

d. 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 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).[34] 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.[35]

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

[33] *Cf.* Treas. Reg. § 1.892-2T(c)(1)(iii).
[34] *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").
[35] *See* section 856(g) and Treas. Reg. § 1.856-8(c)(2).

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 a 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-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.

D. 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.

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
> (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",[36] 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, or, alternatively, does not apply to a subsidiary REIT if more than 50% of the voting power or value of which is owned by 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 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

[36] 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.

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 situations[37] 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, 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.[38] 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.

[37] 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.

[38] 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.

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 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:

	2015	2016	2017	2018	2019
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. [39]

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.[40] 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

[39] Alternatively, the Form 972 could treat $18 as a dividend and not address the $2. The rationale for not referring to the $2 return of capital is that if the shareholders are treated as receiving this amount, they will automatically also be treated as recontributing it. Thus, there will be no net effect of the $2 on basis.

[40] *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.

> 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.

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. [41]

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.

[41] 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.

E. Definition of Congregate Care Facility

NAREIT commends the IRS and the Treasury Department for its efforts and success in issuing private letter rulings (PLRs) over the past few years in the REIT area that effectuate Congressional intent and are consistent with current market practices in the health care industry. As a result, and as discussed in more detail in our March 23, 2016 written submission to the IRS and Treasury Department, we do not believe that additional guidance is needed or merits priority attention. Based on the ruling practices of the IRS in several private letter rulings dealing specifically with such facilities, health care REITs have developed a good working understanding that the IRS and the Treasury Department currently interpret the definition of a "congregate care facility" as an age-restricted community, where, in addition to providing communal dining and living quarters, services are provided to advance the health and physical well-being of its residents. These rulings have provided sufficient guidance for health care REITs and advisors to determine whether a facility meets the definition or which additional health and wellness-related services should be provided to bring a facility within the definition.

* * * * *

All of the suggested projects above would fulfill the goals and objectives set forth in Notice 2017-28.

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, the recommended guidance would reduce controversy and lessens the burden on taxpayers or the Service.

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

Fourth, the recommended guidance would be in accordance with Executive Order 13771 (82 F.R. 9339) and Executive Order 13777 (82 F.R. 12285). We would be happy to work with you to identify existing guidance with respect to which withdrawal may be appropriate in order to comply with Executive Order 13771. As noted above, we recommend withdrawal of Notice 2007-55 and the congregate care facility item on last year's PGP.

Fifth, the recommended guidance promotes sound tax administration.

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

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

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 Senior Vice President and Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

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