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August 4, 2017

VIA ELECTRONIC SUBMISSION [Notice.Comments@irscounsel.treas.gov]

Internal Revenue Service
CC:PA:LPD:PR (Notice 2017-38)
Room 5205
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Notice 2017-38: Temporary Regulations under Section 337(d) on Certain Transfers of Property to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) (T.D. 9770; 81 F.R. 36793) and Temporary Regulations under Section 752 on Liabilities Recognized as Recourse Partnership Liabilities (T.D. 9788; 81 F.R. 69282)

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT)® appreciates the opportunity to offer our comments and recommendations to the Treasury Department and Internal Revenue Service (the IRS) in response to Notice 2017-38, with respect to: 1) the Final Regulations under Section 337(d) on Certain Transfers of Property to RICs and REITs[1], relating to conversions of entities from, and transfers of assets by, C corporations[2] to REITs or RICs[3] under section 337(d) (2017 REIT Regulations);[4] and, 2) the Temporary Regulations under Section 752 on Liabilities Recognized as Recourse Partnership Liabilities (Section 752 Regulations).[5] In both cases, NAREIT believes that these regulations impose undue financial burdens on United States taxpayers and add undue complexity to Federal tax laws, both of which are concerns of Executive Order 13789.

[1] T.D. 9810, 82 Fed. Reg. 5387, modifying T.D. 9770, 81 Fed. Reg. 36793; *see also* the parallel proposed regulations to T.D. 9770 in 81 Fed. Reg. 36816 (2016 REIT Regulations). The preamble to T.D. 9810 specifically noted that the "Treasury Department and the IRS continue to study the other issues addressed in [T.D. 9770] … and welcome further comment on those issues." Because both the 2017 REIT Regulations and the 2016 REIT Regulations are so connected, this letter includes comments related to both sets of regulations.
[2] Although REITs and RICs clearly are C corporations (*see, e.g.,* I.R.C. § 1361(a)(2)), for purposes of this letter "C corporations" refers to C corporations other than REITs and RICs.
[3] Although the 2016 REIT Regulations address both REITs and RICs, this submission will address only REITs.
[4] Unless otherwise provided, any reference to "section" in this letter shall be to a section of the Internal Revenue Code of 1986, as amended (the Code).
[5] T.D. 9788, 81 F.R. 69282. The relevant proposed regulations (REG–119305–11) were issued Feb. 17, 2014 (Proposed Section 752 Regulations).

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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. We represent a large and diverse industry including equity REITs, which own commercial properties, mortgage REITs, which invest in mortgage securities, REITs traded on major stock exchanges, public non-listed REITs and private REITs. Public U.S. REITs collectively own nearly $2 trillion of real estate assets and, by making investment in commercial real estate available in the form of stock, our REIT members carry out Congress' intent to enable all investors – importantly, small investors – to achieve what once only large institutions and the wealthy could.

EXECUTIVE SUMMARY

I. 2017 REIT Regulations

The Protecting Americans from Tax Hikes Act of 2015 (the PATH Act) was enacted as part of Pub. Law 114-113, the "Consolidated Appropriations Act, 2016," and signed into law on December 18, 2015. 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.[6] 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 (BIG) recognition period (currently five years) and pay tax at the corporate level on any BIG recognized during that period, 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 (Automatic Deemed Sale Rule). 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. This general rule does not apply if both the distributing corporation and the controlled corporation are REITs immediately after the distribution (the REIT-Only Spin-Off Exception).[7]

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. The PATH Act allows, however, for a C corporation to elect REIT status and spin-off a controlled taxable REIT subsidiary, provided that the spin-off occurs at least 3 years after the REIT conversion (the TRS Spin-Off Exception).[8] Additionally, the PATH Act does not prevent a C corporation that participated in a spin-off transaction from being acquired by a new or existing REIT, except to the extent the REIT elects to be a REIT within 10 years of the spin-off and the REIT is treated as a successor of the C corporation. The PATH Act does not provide the meaning of "successor" in this context.[9]

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[6] *See* section 1374(d)(7)(A).
[7] Section 355(h)(2)(A).
[8] Section 355(h)(2)(B).
[9] Letter from Tony M. Edwards, Exec. Vice President and Gen. Counsel, NAREIT, to the IRS (May 16, 2016) (NAREIT requested guidance on the meaning of "successor" in this context).

Although the 2016 REIT Regulations originally provided that the BIG recognition period under section 1374 was 10 years for REITs, following notice, comment and a public hearing, the IRS appropriately realigned the BIG period to five years in accordance with the PATH Act changes to section 1374 and Congressional intent.[10] NAREIT strongly believes that there is no reason to make any changes to this BIG period.

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).[11]

To avoid unnecessary and unwanted restrictions on commercial transactions that Congress never intended to be covered by the PATH Act changes, we reiterate the suggestions from our July 19, 2016 letter and once again recommend that the 2016 REIT 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;

b) be modified so that the result of application of the Automatic Deemed Sale Rule is limited to the BIG at the time of the spin-off transaction in 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 the 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, conversely, any Conversion Transaction not completed within that period is presumed not to be part of a plan with the spin-off transaction.

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[10] T.D. 9810.

[11] On June 27, 2016, the Treasury Department and the IRS issued a technical correction to the effective date of the 2016 REIT 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 REIT 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.

In connection with the 2017 REIT Regulations, NAREIT reiterates the recommendations included in its May 30, 2017 letter to the IRS regarding the IRS' 2017-18 Priority Guidance Plan (Priority Guidance Plan Letter) as those comments relate to the 2017 REIT Regulations and the 2016 REIT Regulations.[12] For your convenience, this letter reproduces below the relevant portions of our earlier comments relevant to the above requests. If substantially all of these requested changes are not adopted in final regulations, NAREIT suggests that the proposed regulations be withdrawn.

II. <u>Liabilities Recognized as Recourse Partnership Liabilities</u>

In addition, NAREIT again supports the comments included in the April 29, 2014 letter signed by a number of national real estate organizations, including NAREIT, that requested a withdrawal or the substantial revisions of the Proposed Section 752 Regulations regarding allocations of partnership liabilities (the NREO Letter).[13] The final Section 752 Regulations make significant changes to the allocation of partnership recourse liabilities. By disregarding legitimate guarantees, including so-called "bottom dollar guarantees," these regulations could interfere with liquidity in the commercial real estate market. On April 7, 2017, The Real Estate Roundtable (of which NAREIT is a member) sent a letter to the Treasury Department specifically requesting, *inter alia*, withdrawal of the Section 752 Regulations (the RER Letter). NAREIT reiterates the request for withdrawal of these regulations.

DISCUSSION

I. Transfers of Appreciated Property by Non-REIT C Corporations to RICs and REITs/REIT Spin-Offs

A. Background

The 2016 REIT Regulations are overly and unnecessarily broad in defining when a C corporation has been involved in a spin-off for purposes of imposing deemed sale treatment on a Conversion Transaction.[14] In particular, deemed sale treatment is imposed if either the C corporation itself or any member of the C corporation's SAG participated in a spin-off, either as the distributing corporation or as the controlled corporation. Additionally, the 2016 REIT Regulations provide

[12] Although not specifically the subject of Notice 2017-38, NAREIT reiterates the comments in the Priority Guidance Plan letter requesting that the suggestions included in its October 7, 2016 comments regarding the proposed regulations under section 355 concerning device and active trade or business (REG-134016-15) (the Proposed ATB Regulations) be adopted in order to narrow the application of those regulations. If these suggested changes are not possible, NAREIT requests that the Treasury Department withdraw these regulations. Also, although outside the purview of spin-offs, NAREIT strongly requests the withdrawal of IRS Notice 2007-55, which is a restraint on needed investment by non-U.S. investors in real estate infrastructure.
[13] *See also* Comments on Proposed Regulations under Sections 707 and 752 by the Tax Section of the American Bar Association, dated August 8, 2014, requesting withdrawal or substantial revision of these regulations.
[14] The broadness of the 2016 REIT Regulations seems particularly unnecessary in light of the Proposed ATB Regulations. If finalized, these regulations would further limit the ability of corporations holding assets suitable to be held in a REIT to engage in tax-free spin-offs. *See* Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(C).

that references to controlled and distributing corporations include any predecessor or successor of such corporation.[15] For this purpose, "predecessor" and "successor" are defined to "include" entities that have engaged in certain tax-free transactions in which one entity succeeds to the tax attributes of the other entity under section 381 (for example, tax-free reorganizations and liquidations).

The excessively sweeping scope and effect of these provisions can be illustrated with the following example. Suppose that:

- Two real estate C corporations (BigCo A and BigCo B) each hold assets worth $1 billion with $0 basis.
- BigCo A owns 100% of the stock of a subsidiary C corporation (Sub 1) holding assets worth $20 million with $0 basis.
- Sub 1 owns 100% of the stock of a subsidiary C corporation (Sub 2) holding assets worth $10 million with $0 basis.
- In Year 1, BigCo A spins off Sub 1 in a tax-free transaction under section 355.
- In Year 3, BigCo B acquires Sub 2 in a tax-free transaction under section 381, at a time when BigCo B has no plans to convert to a REIT.
- In Year 9 (*i.e.*, years after BigCo B's acquisition of Sub 2 but within 10 years of the spin-off of Sub 1), BigCo B converts to a REIT.

Under the PATH Act, if Sub 1 had converted to a REIT in connection with its Year 1 spin-off, the maximum amount of BIG subject to tax on the spin-off would have been $20 million, which equals the BIG on the assets of Sub 1. Under the 2016 REIT Regulations, however, Sub 2 has been virally "tainted" by Sub 1's activities in Year 1. Accordingly, BigCo B's tax-free acquisition of relatively tiny Sub 2 in Year 3 qualifies BigCo B as the "successor" to an entity (Sub 2) whose SAG member (Sub 1) had undergone a related tax-free spin-off within 10 years before the REIT conversion of its "successor". Therefore, the 2016 REIT Regulations would force BigCo B to pay tax on the BIG on its entire $1.01 billion of assets (the $1 billion BigCo B owned in Year 0 plus the $10 million of the Sub 2 assets it acquired in Year 3) in Year 9.[16] As

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[15] Treas. Reg. § 1.337(d)-7T(f)(2) ("Predecessors and successors include corporations which succeed to and take into account items described in section 381(c) [(such as earnings and profits)] of the distributing corporation or the controlled corporation, and corporations having such items to which the distributing corporation or the controlled corporation succeeded and took into account.").

[16] The 2016 REIT Regulations contain certain ambiguous language that raises the possibility that the scope of the Automatic Deemed Sale Rule may be even broader than is illustrated by the example above. A number of uncertain issues would be raised if, as a variation of the example above:

1. BigCo B had not converted into a REIT but instead had merged into another C corporation (BigCo C) and then BigCo C converted into a REIT (*i.e.*, is BigCo C a "successor" to Sub 2?);
2. BigCo B had acquired the stock of Sub 2 in a transaction in which Sub 2 became part of BigCo B's SAG (*i.e.*, is the concept of SAG tested only at the time of the related spin-off or does it remain relevant for the entire 10-year period?); or
3. BigCo B was acquired by a REIT in a fully taxable transaction (*i.e.*, given that Treas. Reg. § 1.337(d)-7T(f)(2) defines "predecessor" and "successor" to "include" entities that have engaged in certain tax-free transactions, so can other transactions or situations also cause companies to be "included" in "predecessor" and "successor"?).

this example illustrates, under the 2016 REIT Regulations' excessive sweep, the tail can wag the dog.

The 2016 REIT Regulations ostensibly are designed to ensure that certain transactions are not used to circumvent the Congressional policy underlying the PATH Act, which is to eliminate the ability of C corporations to participate in tax-free REIT spin-offs.[17] However, the 2016 REIT Regulations currently go beyond the aim of the PATH Act and unnecessarily affect many more transactions than would be necessary to achieve Congressional aims, including presently uncontemplated transactions. In this example, if the spin-off of Sub 1 by BigCo A in Year 1 had been fully taxable, the maximum income tax owed to the fisc would likely have been $9.6 million (calculated using a 35% corporate tax plus a 20% tax to shareholders on the after-tax amount). However, neither BigCo A nor Sub 1 had any intent to convert any of its activities to a REIT, and neither did BigCo B when it acquired Sub 2 in Year 3. Six years later in Year 9, the maximum income tax owed by BigCo B under the 2016 REIT Regulations could be at least $350 million (a 35% corporate tax on the $1.01 billion of BIG), which arises solely because of its acquisition of Sub 2 in Year 3.

Additionally, the 2016 REIT Regulations effectively eliminate certain exceptions to the PATH Act's prohibition on tax-free spin-off transactions. As under the PATH Act, the Automatic Deemed Sale Rule does not apply if the TRS Spin-Off Exception applies. However, the 2016 REIT Regulations narrow the scope of the REIT-Only Spin-Off Exception, without an apparent policy basis. The PATH Act does not prohibit tax-free REIT spinoffs if both the distributing corporation and the controlled corporation are REITs immediately after the distribution; the 2016 REIT Regulations impose the Automatic Deemed Sale Rule unless both the distributing corporation and the controlled corporation are REITs immediately after the distribution and *remain* so for two years after the distribution.[18] For example, under the PATH Act, if a REIT spins off a subsidiary that immediately elects to be subject to tax as a REIT, the spin-off may qualify as tax-free under section 355. Under the 2016 REIT Regulations, if the controlled corporation were to fail to qualify as a REIT in the next two years, both the distributing corporation and the controlled corporation would immediately be subject to the Automatic Deemed Sale Rule.

NAREIT encourages the Treasury Department and the IRS to consider the types of difficult issues raised by these examples when evaluating both the recommendations contained in this letter and also the 2016 REIT Regulations more generally.

[17] The Preamble to the 2016 REIT Regulations states that "there is concern that corporations affiliated with the distributing corporation or the controlled corporation could be used to circumvent the Congressional policy implemented through section 311 of the PATH Act". 81 Fed. Reg. 36796. As the above example illustrates, the reach of the 2016 REIT Regulations can disproportionately extend to existing REITs not affiliated with a distributing or controlled corporation other than engaging in an arm's length "old and cold" transaction many years after a spin-off.

[18] *See* Treas. Reg. § 1.337(d)-7T(f)(3)(i).

B. Recommendation: Limit the Scope of the Automatic Deemed Sale Rule

NAREIT respectfully recommends that the IRS limit the scope of the Automatic Deemed Sale Rule in order to provide a fair and workable standard that achieves the purposes of the PATH Act. In the preamble to the 2016 REIT Regulations, the Treasury Department and the IRS expressed concern that certain transactions could be used "to circumvent the Congressional policy implemented through section 311 of the PATH Act."[19] NAREIT appreciates the Treasury Department's desire "to prevent abuses of sections 355(h) [the rule generally preventing REIT spin-offs] and 856(c)(8) [the rule preventing entities that have engaged in spin-offs from electing REIT status]."[20] The Automatic Deemed Sale Rule, however, goes beyond the Congressional policy underlying these Code sections in a number of respects.

To better achieve the purposes of the PATH Act, we recommend that:

a. The Automatic Deemed Sale Rule only apply when the Conversion Transaction and the accompanying spin-off are part of the same plan.

b. The amount of gain recognized by a REIT as a result of application of the Automatic Deemed Sale Rule be limited to the BIG at the time of the spin-off transaction in 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 SAG of either 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.[21] We recommend that the amount of such gain be adjusted to take into account the amount of any such BIG already recognized by the distributing corporation or the controlled corporation.

c. The Automatic Deemed Sale Rule not apply if both the distributing corporation and controlled corporation in a tax-free spin-off transaction are REITs immediately after the transaction, regardless of whether both the distributing corporation and controlled corporation remain REITs for two years.

d. The 2016 REIT Regulations adopt a 2-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, conversely, any Conversion Transaction not completed within that period is presumed not to be part of a

[19] T.D. 9770, s*upra* note 1.
[20] *Id*.
[21] In order to ensure that a corporation is properly subject to tax under the Automatic Deemed Sale Rule, NAREIT also recommends that if any asset held by the distributing corporation or controlled corporation (or a SAG member of either) is exchanged for a new asset in a transaction in which the basis of the new asset is determined (in whole or in part) by reference to the adjusted basis of the disposed asset, such new asset also should be treated as if it had been held by the distributing corporation or controlled corporation at the time of the spin-off transaction. The Code contains similar provisions regarding the application of section 1374 to property held by an S corporation, the basis of which is determined by reference to section 1374 property. *See* section 1374(d)(6).

> plan with the spin-off transaction. We also recommend that rules and notifications similar to the safe harbor rules of section 355(e) and the disguised sale rules of section 707(a)(2)(B) be made applicable within this context.[22]

As discussed above, Congress generally intended for the PATH Act to render REIT spin-offs taxable.[23] We understand the 2016 REIT Regulations are intended in part to address certain transactions that the Treasury Department and the IRS may consider abusive with respect to this purpose of the PATH Act. One such transaction that might be considered abusive is a C corporation spinning off a subsidiary C corporation just before one of those C corporations merges into or is acquired by a REIT in a tax-free acquisition. We agree that this type of transaction may be inconsistent with the spirit of the PATH Act if the spin-off were undertaken as part of plan to merge the distributing corporation or the controlled corporation into a REIT (especially one that was newly formed).[24] Such a plan would allow the distributing and controlled corporation's shareholders to spin off a subsidiary and have that subsidiary's assets held by a REIT—largely the same result as if the subsidiary had itself elected REIT status. In general, NAREIT believes that existing step-transaction principles provide the appropriate and adequate means to police these transactions.

However, the Treasury Department and the IRS should create rules that give both the IRS and taxpayers greater clarity in determining whether a transaction should be within the scope of the regulations. We therefore understand the rationale for the Treasury Department's adoption of a bright-line "blackout" period during which the Automatic Deemed Sale Rule applies.

At 20 years, however, the 2016 REIT Regulations' "blackout" period is too long to be an appropriate measure of the types of transactions that can reasonably be viewed as circumventing the PATH Act and the repeal of *General Utilities*. Instead, NAREIT's suggested approach of a 2-

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[22] *See also* Treas. Reg. §§ 1.355-7 and 1.707-3.

[23] *See* Joint Committee on Taxation, *Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029* at 170 (Dec. 17, 2015) ("[section 311 of the PATH Act] makes a REIT generally ineligible to participate in a tax-free spin-off as either a distributing or controlled corporation under section 355.")

[24] With that said, we note that the PATH Act added section 856(c)(8), which provides:

> If a corporation was a distributing corporation or a controlled corporation (other than a controlled corporation with respect to a distribution described in section 355(h)(2)(A)) with respect to any distribution to which section 355 (or so much of section 356 as relates to section 355) applied, such corporation (and any successor corporation) s**hall not be eligible to make any election under paragraph (1)** for any taxable year beginning before the end of the 10-year period beginning on the date of such distribution.

(Emphasis added).

A C corporation makes a REIT election by filing a Form 1120-REIT. The instructions to the Form 1120-REIT provide: "[t]he election to be treated as a REIT **remains in effect** until terminated, revoked, or the REIT has failed to meet the requirements of the statutory relief provisions." (Emphasis added). Thus, by its terms, the merger of a C corporation into an existing REIT does not constitute a new REIT election, and, therefore, is not technically affected by the PATH Act. For that reason, regulations that expand upon the PATH Act's provisions in order to prevent perceived abuses should be narrowly tailored.

year presumption rule is not only more appropriate conceptually but also is consistent with the types of rules Congress and the Treasury Department have adopted in related contexts.

For example, REITs are generally prohibited from selling real estate held by the REIT as inventory, and proceeds from the sale of inventory by a REIT are subject to a 100% tax.[25] In order to provide taxpayers with a bright line rule to ensure that they are not treated as selling real estate as inventory, section 857 provides that property held by the REIT for at least two years for the production of rental income or in connection with the trade or business of producing timber (and satisfying other tests) can be treated as held for long-term investment, not inventory.[26] Prior to 2008, a REIT was required to hold property for at least four years in order to satisfy this safe harbor. In shortening the safe harbor period, Members of Congress expressed concern that four years was "simply too long a time in today's marketplace"[27] to use as a litmus test of a REIT's intent to hold property for long-term investment, and that "a 2-year holding period better reflects current economic realities."[28] NAREIT believes that similar economic realities support the use of a 2-year presumption for purposes of determining whether a real estate corporation participating in a spin-off intends to engage in a REIT conversion as part of a plan with the spin-off.

Furthermore, NAREIT's suggested approach is consistent with Congress' and the Treasury Department's approach in analogous scenarios. For example, section 355(e) was passed in part to prevent a transaction that Congress viewed as abusive in connection with tax-free spin-offs when shareholders sold the majority of the controlled corporation's stock after the distribution.[29] Such a transaction allowed shareholders to reach a similar place as if the distributing corporation had sold the stock of the controlled corporation and distributed the sale proceeds to its shareholders, but without the layer of corporate tax imposed on the sale. In order to curb these transactions, section 355(e) requires a distributing corporation to recognize gain in connection with an otherwise tax-free spin-off if a 50% or greater interest in either the distributing or controlled corporation is acquired pursuant to a plan that includes the distribution. A plan is presumed to exist if a 50% or greater interest is acquired within the 2-year periods preceding and following the distribution.

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[25] *See* sections 857(b)(6)(B)(iii) and 1221(a)(1).
[26] *See s*ections 857(b)(6)(C)(i) and 857(b)(6)(D)(i).
[27] *See, e.g.,* 153 Cong. Rec. S10932 (2007) (statement of Sen. Hatch) ("Congress has always wanted REITs to invest in real estate on behalf of their shareholders for the long term. Since the late 1970s, the mechanism to carry out these purposes has been a 100 percent excise tax on a REIT's gain from so-called 'dealer sales.' Because the 100 percent tax is so severe, Congress created a safe harbor under which a REIT can be certain that it is not acting as a dealer (and therefore not subject to the excise tax) if it meets a series of objective tests. This provision would update two of these safe harbor requirements. The current safe harbor requires a REIT to own property for at least four years. This is simply too long a time in today's marketplace. Further, four years departs too much from the most common time requirement for long-term investment—the one-year holding period for an individual's long-term capital gains. Accordingly, this provision uses a more realistic two-year threshold.")
[28] *Cf.* 153 Cong. Rec. E385 (2007) (statement of Rep. Crowley) ("However, the 4-year requirement is arbitrary and not consistent with other Code provisions that define whether property is held for long term investments. . . . A 2-year holding period better reflects current economic realities.").
[29] *See, e.g.*, H.R. Conf. Rep. No. 105-220, at 528 (1997).

Given the similarities in context between section 355(e) and the 2016 REIT Regulations, NAREIT recommends a similar presumption be incorporated into the 2016 REIT Regulations, as discussed above. As another example of how NAREIT's recommendation is consistent with analogous scenarios, the Treasury Department and the IRS have adopted a similar rule in the context of determining whether a partner and partnership have engaged in a disguised sale. The regulations under section 707 contain a 2-year presumption that if, within a 2-year period in either order, a partner transfers property to a partnership and the partnership transfers money to the partner, the transfers constitute a disguised sale of the property.[30]

The example described above illustrates the advantages of our recommended 2-year presumption. Under the 2016 REIT Regulations, if BigCo B, a C corporation, acquires Sub 2 (a spun-off C corporation) 2 years after Sub 1 (Sub 2's former parent) was spun off, and BigCo B converts to a REIT 6 years later, BigCo B is subject to the Automatic Deemed Sale Rule, with the harsh results described above. We believe that a REIT conversion that occurs 8 years after a tax-free spin-off is unlikely to have occurred as part of a plan with the spin-off and, further, that if the conversion is not part of a plan with the spin-off, the transactions are unlikely to be used "to circumvent the Congressional policy implemented through section 311 of the PATH Act."[31] On the other hand, a Conversion Transaction that occurs within two years of a tax-free spin-off is more likely to have occurred as part of a plan with the spin-off, and therefore more likely to be the sort of transaction with which the 2016 REIT Regulations are concerned. We believe that our proposed 2-year presumption offers a reasonable compromise between the need for an easily administrable bright-line "blackout" period for the Automatic Deemed Sale Rule and the need to avoid subjecting to tax transactions that do not circumvent the Congressional policy underlying the PATH Act, and that our proposal is consistent with regulations governing analogous scenarios.[32]

We note that, although the PATH Act's prohibition on REIT elections following spin-offs is for 10 years, that 10-year period is not an appropriate analogy on which the Automatic Deemed Sale Rule should be based, most importantly because the scope of the Automatic Deemed Sale Rule, and its effect when it applies, are much broader than the scope and effect of the PATH Act provisions. In other words, it is especially important to narrowly tailor the application of the Automatic Deemed Sale Rule because the rule as currently drafted goes well beyond the Congressional policy underlying the PATH Act.

Specifically, the PATH Act's prohibition on REIT spin-offs denies tax-free treatment under section 355, while the 2016 REIT Regulations impose harsher consequences. As discussed above, under the PATH Act, if a spin-off does not qualify for tax-free treatment, there are two primary consequences. First, the distributing corporation is generally required to recognize gain as if it had sold the stock of the controlled corporation to its shareholders. Second, the shareholders receiving the stock of the controlled corporation in the spin-off are generally treated

[30] Treas. Reg. § 1.707-3(c)(1).
[31] T.D. 9770, *supra* note 1.
[32] *See* sections 355(e) and 707(a)(2)(B) and Treas. Reg. §§ 1.355-7 and 1.707-3.

as having received a taxable distribution equal to the fair market value of the controlled corporation's stock.[33]

Under the 2016 REIT Regulations, however, if a C corporation were to spin off a subsidiary C corporation tax-free and then be acquired by a REIT, the distributing C corporation itself would be subject to the Automatic Deemed Sale Rule on its conversion to a REIT. The rule would subject the distributing corporation to tax on the BIG in *all* of its assets, not just on the stock of the subsidiary C corporation as required by the PATH Act. Additionally, if the acquiring REIT held any assets within that REIT's own recognition period, the acquisition of the distributing corporation apparently would also cause the acquiring REIT to be subject to the Automatic Deemed Sale Rule with respect to those assets. In other words, as drafted the 2016 REIT Regulations go beyond their stated goal to prevent "circumvent[ion] of the Congressional policy implemented through section 311 of the PATH Act" (which simply requires REIT spin-offs to be taxable), by potentially imposing a far greater amount of tax on a far wider group of taxpayers than contemplated by the PATH Act.

Additionally, Congress precisely defined the scope of the PATH Act's prohibition on REIT spin-offs. While a C corporation generally may not participate in a tax-free REIT spin-off as either a distributing corporation or a controlled corporation under section 355, Congress decided to allow a REIT to spin-off a taxable REIT subsidiary—a C corporation by definition— provided that the REIT has been a REIT for at least three years prior to the spin-off. Similarly, Congress provided that the PATH Act's prohibition on tax-free spin-offs does not apply if the REIT-Only Spin-Off Exception applies, *i.e.*, if both the distributing corporation and controlled corporation are REITs immediately after the spin-off.

NAREIT believes that if Congress had intended to limit other spin-off transactions it would have done so explicitly. For example, nothing in the PATH Act prevents a C corporation from spinning off a subsidiary C corporation tax-free provided the requirements of section 355 are met and neither C corporation elects REIT status for 10 years. Under the 2016 REIT Regulations, if any member of either corporation's SAG were to elect REIT status within the 20-year window described above, that affiliated corporation would be subject to the Automatic Deemed Sale Rule, despite being unconnected to the spin-off and completely outside the purview of the PATH Act. Similarly, the 2016 REIT Regulations apply the Automatic Deemed Sale Rule to a spin-off otherwise treated as tax-free under the REIT-Only Spin-Off Exception if either the distributing corporation or controlled corporation ceases to be REIT within two years of the spin-off. The PATH Act does not prohibit such spin-offs, and nothing in the legislative history to the PATH Act indicates that Congress intended to limit section 355 in this manner. NAREIT believes that it is inappropriate for the 2016 REIT Regulations to broaden the scope of the PATH Act in a manner that was not intended by Congress.

The 2016 REIT Regulations' narrowing of the REIT-Only Spin-Off Exception is particularly troubling because it may effectively eliminate, rather than simply narrow, the REIT-Only Spin-

[33] Section 301(c). Of course, following a taxable distribution, a spun-off C corporation is free to convert to a REIT.

Off Exception. Under the PATH Act, if a REIT spins-off a subsidiary that elects REIT status in connection with the spin, the distributing corporation can be confident that the spin-off will be tax-free if the requirements of section 355 are met. Under the 2016 REIT Regulations, the tax treatment of the distributing corporation may be altered by actions taken up to two years later that may be completely outside the distributing corporation's control. For example, if the controlled corporation were to fail any of its REIT tests within two years of the spin-off transaction, both the controlled corporation and the distributing corporation would suffer adverse tax consequences under the Automatic Deemed Sale Rule. A REIT may be unwilling to spin-off a subsidiary REIT in light of this uncertainty, despite the fact that Congress clearly intended to provide an exception to the PATH Act for REIT spin-offs from other REITs.[34] Accordingly, NAREIT believes that the 2016 REIT Regulations' narrowing of the REIT-Only Spin-Off Exception runs counter to Congressional intent.

NAREIT also believes that it is important to limit the scope of the Automatic Deemed Sale Rule because the rule imposes significant economic costs in every future REIT acquisition transaction. First, the 2016 REIT Regulations will require many acquiring corporations to conduct a prohibitive amount of diligence to ensure that a target corporation will not inadvertently cause the acquiror to be subject to the Automatic Deemed Sale Rule. Often, it will be impossible to reach a level of certainty sufficient to proceed with a transaction. For example, if a C corporation becomes a member of a REIT's SAG (whether by an acquisition or otherwise), the REIT risks being subject to the Automatic Deemed Sale Rule and thus being subject to tax on the BIG in all its assets within the recognition period unless it can be sure that the target C corporation did not participate in a tax-free spin-off within 10 years of the REIT's conversion and is also not a successor or predecessor to any corporation that participated in a tax-free spin-off.[35]

For example, under the 2016 REIT Regulations, in order for a REIT to acquire a C corporation in a section 381 transaction without risking the imposition of the Automatic Deemed Sale Rule, the REIT must conclude that the following corporations were not, during the past 10 years, involved in a tax-free spin-off as either the distributing corporation or the controlled corporation: i) the target corporation; ii) any corporation acquired by the target corporation in a section 381 transaction (a target once removed); iii) any corporation acquired by the target once removed in a section 381 transaction; and, iv) any other corporation further along the section 381 acquisition chain. Given the volume of acquisitions in the C corporation space, this viral nature of the

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[34] Additionally, we note that the application of the Automatic Deemed Sale Rule to the controlled corporation in this example seems inconsistent with the policy underlying section 1374 and *General Utilities* repeal more generally. Section 1374 is generally intended to prevent a corporation from escaping corporate-level tax by converting to an S corporation, RIC, or REIT and selling assets with built-in gain tax-free. In the example above, however, the controlled corporation *ceases* to be a REIT, meaning that assets are moving from a REIT to a C corporation. It is unclear why the Automatic Deemed Sale Rule would be required in such circumstances.

[35] These diligence efforts would be further complicated because "predecessor" and "successor" are defined to "include" entities that have engaged in certain tax-free transactions, which leaves open the possibility that other transactions or situations may give rise to status as predecessors or successors. Thus, the successor and predecessor rules may be especially difficult to adequately diligence.

Automatic Deemed Sale Rule may, especially in the public company context, create an insurmountable tax due diligence problem.

Second, the 2016 REIT Regulations create strong disincentives with respect to certain acquisitions. For example, a C corporation that holds real estate may avoid acquiring another C corporation if the target has recently engaged in a tax-free spin-off, because the acquiror will effectively be prevented from electing REIT status in the next 10 years.

Third, the potential costs of running afoul of the 2016 REIT Regulations are disproportionate to the transactions that the 2016 REIT Regulations are designed to limit. For example, if a $20 million C corporation converts to a REIT and immediately spins off a $5 million C corporation subsidiary, the BIG on the spin-off will be taxable immediately under the PATH Act. Assuming the $20 million C corporation has zero basis in the stock of the $5 million subsidiary, the maximum federal income tax imposed on the spin-off would likely be $2.4 million (calculated using a 35% corporate tax plus a 20% tax on the shareholders receiving stock of the subsidiary). However, instead of converting to a REIT, if the $20 million C corporation spun off its subsidiary and then merged (when it was worth $15 million) with a $1 billion REIT within the next 10 years, the $1 billion REIT would be required to recognize all of the BIG in its assets, to the extent that gain is subject to section 1374 treatment. As in the earlier example, this tax could be as much as $350 million.

This result—a tax nearly 150 times the tax that would have been imposed had the spin-off simply been taxable—seems particularly disproportionate in light of the PATH Act's purpose of preventing tax-free spin-off transactions involving REITs. Furthermore, NAREIT believes that this approach is inconsistent with the IRS' and the Treasury Department's general approach with respect to the amount of gain recognized in connection with otherwise tax-free spin-offs under section 355.[36]

NAREIT's proposal would limit gain recognized under the Automatic Deemed Sale Rule to the BIG in assets that are both held by a corporation participating in the spin-off transaction and held by a corporation participating in the Conversion Transaction. Under this proposal, the gain recognized on the Conversion Transaction in the example above would be limited to $15 million—the BIG at the time of the spin-off in the assets that were both held by distributing corporation at the time of the spin-off (assuming the distributing corporation had zero basis in its assets) and held by the distributing corporation at the time of the Conversion Transaction. Such gain would further be reduced if and to the extent the controlled corporation had recognized such BIG in its assets prior to the Conversion Transaction. For example, if the controlled corporation

[36] *See* Prop. Treas. Reg. § 1.355-8(e), which provides rules limiting the amount of gain recognized under section 355(e) when there is an acquisition of 50% or more of the stock of the predecessor of the distributing corporation, but not of the distributing corporation itself. *See also* Notice of Proposed Rulemaking, Fed. Reg. Vol. 79, No. 11 (Jan 16, 2014) (noting that "if the excess of the gain inherent in the Controlled stock on the date of the distribution over the gain attributable to the assets of the predecessor is small relative to the full amount of gain inherent in the Controlled stock, it may seem inappropriate to require that Distributing recognize the full amount of gain inherent in the Controlled stock.")

had sold some of its assets to the converting corporation in a taxable transaction, the controlled corporation would not be required to recognize gain with respect to those assets a second time.

Absent these proposed limits, the possibility of viral and disproportionate results under the Automatic Deemed Sale Rule increases the relative cost of diligence. These costs coupled with the broad scope and effect of the regulations described above would impose incredible, and we suspect unforeseen, diligence burdens on participants in regular, everyday merger and acquisition activity.

II. Liabilities Recognized as Recourse Partnership Liabilities

The Section 752 Regulations address the allocation of partnership liabilities and whether certain obligations, including bottom dollar guarantees and bottom dollar deficit restoration obligations, are recognized for the purposes of determining a partner's share of recourse liabilities. These Section 752 Regulations largely finalized the earlier Proposed Section 752 Regulations, and NAREIT's concerns and recommendations about the Proposed Section 752 Regulations remains the same, as stated in both the NREO Letter and the RER Letter. Accordingly, NAREIT recommends withdrawal of these regulations.

In particular, as noted in the RER Letter:

> The Section 752 Regulations will greatly restrict the ability of individuals to pool their capital, property, and expertise for productive real estate activities. The partnership liability allocation rules have important implications for the movement of real estate in common partnership contribution transactions, whether involving a single property or a portfolio of properties in roll-up transactions and REIT transactions using umbrella partnership (UPREIT) structures. Today, UPREIT structures and partnership roll-up transactions allow individual property owners to diversify their investments and obtain greater liquidity and transparency with respect to their property ownership interests in a tax-deferred transaction akin to a tax-deferred corporate reorganization. Liability guarantees are widely used in connection with these transactions in order to match the allocation of partnership liabilities with the partner with risk of loss with respect to the liability and to preserve the deferral of capital gain. Legitimate guarantees allow a partner to accept a risk of economic loss and obtain basis that can be used to deduct allocated losses. Under newly issued regulations under section 752, many guarantees, including bottom dollar guarantees, no longer are recognized for tax purposes. By withdrawing the final and proposed regulations, the Administration could ensure that any new rules do not discourage capital formation, job creation, and economic activity.

Thank you again for the opportunity to submit these comments. Please contact me at tedwards@nareit.com, Catherine Barré, NAREIT's SVP for Policy & Politics, at cbarre@nareit.com, or Dara Bernstein, NAREIT's SVP & Tax Counsel, at dbernstein@nareit.com if you would like to discuss these issues in greater detail.

Respectfully submitted,

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