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May 10, 2019

VIA ELECTRONIC SUBMISSION [www.regulations.gov]

Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-113943-17)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Certain Transfers of Property to Real Estate Investment Trusts; Notice of Proposed Rulemaking (REG-113943-17)

Dear Sir or Madam:

Nareit[1] appreciates the opportunity to offer our comments and recommendations to the Treasury Department and Internal Revenue Service (the IRS) with respect to the 2019 Proposed Regulations (REG-113943-17) (the 2019 Regulations),[2] relating to conversions of entities from, and transfers of assets by, C corporations[3] to real estate investment trusts (REITs) under section 337(d).[4]

As further described below, the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), enacted on Dec. 18, 2015, generally:

(i) eliminated the ability of C corporations to participate in tax-free REIT spin-offs under section 355, either as a distributing corporation or a controlled corporation;
(ii) prohibited a C corporation that has engaged in a tax-free spin-off from electing to be a REIT within 10 years of the spin-off; and,
(iii) made permanent the 5-year period for the recognition of gain under section 1374, which had been reduced from 10 years in amendments to the Code on a temporary basis.[5]

[1] 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.
[2] *See* 84 Fed. Reg. 11,259, as amended by 84 Fed. Reg. 18,999.
[3] Although REITs 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 corporations that are subject to tax under subchapter M.
[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] *See* section 1374(d)(7)(A).

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Final and temporary regulations under section 337(d) (T.D. 9810) (the 2017 Regulations) generally provide that, when a REIT disposes of appreciated property after converting to a REIT from a C corporation or acquiring property from a C corporation in certain carryover basis transactions (a Conversion Transaction), the REIT must apply the rules of section 1374 for the built-in gain recognition period 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. Prior final and temporary regulations (T.D. 9770) issued in 2016 (the 2016 Regulations) had provided that, unlike previous regulations, the definition of recognition period was no longer tied to section 1374,[6] and re-imposed a 10-year recognition period.[7] The 2017 Regulations reinstated the long-established link between section 1374 and the regulations under section 337(d), and the term "recognition period" in the regulations once again cross-references the same term in section 1374.[8]

The 2016 Regulations also generally required deemed sale treatment under section 1374 (with no ability to elect section 1374 treatment) for any C corporation that engages in a Conversion Transaction within 10 years (*i.e.*, before or after) of a tax-free spin-off that involves the converting C corporation (the "Automatic Deemed Sale Rule" and the "Automatic Deemed Sale Period," respectively). Unlike with respect to the section 1374 built-in gains period, the 2017 Regulations did not change this 10-year period to a 5-year period for purposes of imposing a deemed sale election. The 2019 Proposed Regulations have retained this 10-year period.[9]

On April 21, 2017, President Trump issued Executive Order 13789 (E.O. 13789), which instructed the Secretary of the Treasury to review all significant tax regulations issued on or after Jan. 1, 2016, and to take concrete action to alleviate the burdens of regulations that: i) impose an undue financial burden on U.S. taxpayers; ii) add undue complexity to the federal tax laws; or, iii) exceed the statutory authority of the IRS.

The 2019 Regulations generally retain the structure of the 2016 Regulations, including the Automatic Deemed Sale Rule. However, the 2019 Regulations would limit the Automatic Deemed Sale to "distribution property." Distribution property is generally defined as property owned by a distributing corporation or a controlled corporation (or a member of the separate affiliated group of either corporation) immediately after a tax-free spin-off, and other property the basis of which is determined, directly or indirectly, in whole or in part, by reference to that property. As a result of the limitation, gain immediately

[6] *See* T.D. 9770 ("These temporary regulations … delink the determination of the recognition period from the rules of section 1374(d)(7).")
[7] The 2016 final and temporary regulations (T.D. 9770) and proposed regulations (REG-126452-15) were both published on June 8, 2016, with the text of the temporary regulations serving as the text of the proposed regulations.
[8] Treas. Reg. § 1.337(d)-7(b)(2)(iii).
[9] Prop. Reg. § 1.337(d)-7(f)(1)(i).

recognized by a C corporation engaging in a tax-free spin-off and a later conversion transaction would be limited to gain on property traceable to the tax-free spin-off.

Executive Summary

Nareit appreciates the 2019 Regulations' attempt to limit the Automatic Deemed Sale Rule. However, Nareit believes that the 2019 Regulations are inconsistent with Congress' intent in the PATH Act and the directives of E.O. 13789 in certain specific respects. Accordingly, Nareit respectfully recommends that the 2019 Regulations:

(1) be modified so that the Automatic Deemed Sale Rule only applies when a Conversion Transaction occurs in the 10-year period beginning 5 years before a tax-free spin-off;

(2) adopt an exception to the Automatic Deemed Sale Rule when a REIT that acquires property from a C corporation: i) receives a representation that the C corporation (along with specified predecessors and members of the affiliated group of which the C corporation is a member) has not engaged in a "related section 355 distribution," within the meaning of Prop. Reg. § 1.337(d)-7(f)(1); and, ii) has no actual knowledge contrary to such representation; and,

(3) be modified so that the Automatic Deemed Sale Rule will 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 thereafter.

Discussion

A. Background

1. General Utilities and Section 1374

Congress repealed the General Utilities[10] doctrine in the Tax Reform Act of 1986 (TRA). The General Utilities doctrine had generally provided that a corporation recognized no gain or loss on a distribution of its assets to its shareholders in liquidation or, if certain conditions are met, on a liquidating sale of its assets. As part of the repeal of the General Utilities doctrine, the TRA included new section 1374. Under section 1374, when a C corporation that has unrealized (*i.e.*, built-in) gain in its assets converts to an S corporation, the S corporation—though normally not subject to entity-level tax—is required to pay corporate-level tax on any built-in gains that are recognized in a taxable transaction within a "recognition

[10] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 [16 AFTR 1126] (1935).

period." The PATH Act permanently defined "recognition period" as the 5-year period beginning on the first day of the S corporation's first taxable year (*e.g.*, the date on which a C corporation converts to an S corporation).[11]

Section 1374 is intended to ensure that the repeal of the General Utilities doctrine is not circumvented through the use of S corporations. Absent section 1374, a C corporation could convert to S corporation status and either sell assets or liquidate without incurring any tax—exactly the result that Congress intended to prohibit by the repeal of General Utilities. In effect, the section 1374 tax on built-in gains creates a holding period requirement: the built-in gain assets of a former C corporation cannot be disposed of without corporate tax within 5 years of those assets becoming the assets of an S corporation.

The TRA also included section 337(d), which provided authority for the IRS and Treasury Department to promulgate

> such regulations as may be necessary or appropriate to carry out the purposes of the amendments made … by the Tax Reform Act of 1986, including -(1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter) ...

The legislative history indicates that Congress' grant of regulatory authority was also intended to prevent the circumvention of the repeal of the *General Utilities* doctrine "through the use of …the tax-free reorganization provisions of the Code."[12] The Technical and Administrative Revenue Act of 1988 (TAMRA) extended section 337(d) to REITs by adding the words "or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity," after "subchapter)".

Following TAMRA's enactment, in 1988 the IRS issued Notice 88-19,[13] which stated that C corporations converting or merging into REITs should be subject to the same built-in gain recognition rules applicable to C corporations converting or merging into S corporations under section 1374. This guidance was formalized in the regulations issued under section 337(d). The regulations under section 337(d) also allow a C corporation converting or merging into a REIT, in lieu of being subject to the built-in gain recognition rules, to make a "deemed sale election," pursuant to which the C corporation recognizes gain and loss as if it had sold its property to an unrelated party at fair market value on the day before the conversion or merger.[14]

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[11] Section 1374(d)(7).
[12] H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II, at 204 (1986).
[13] Notice 88-19, 1988-1 C.B. 486.
[14] Treas. Reg. § 1.337(d)-7T(c)(6) and Treas. Reg. § 1.337(d)-7(c)(3).

Prior to the issuance of the 2016 Regulations, the definition of "recognition period" for purposes of imposing section 1374 treatment on C corporations converting or merging into REITs cross-referenced the same term in section 1374. As described above, the 2016 Regulations substituted a 10-year recognition period for the reference to section 1374's 5-year recognition period. The 2017 Regulations reinstated the link between section 1374 and the regulations under section 337(d), noting the clear Congressional intent for the 5-year recognition period applicable to S corporations under section 1374 to apply to REITs.[15] The section 337(d) regulations thus effectively adopt the holding period requirement of section 1374—assets cannot be disposed of without corporate tax within 5 years of being moved from a C corporation to a REIT because, unless a deemed sale election is made, the assets remain subject to the built-in gain recognition rules for 5 years.

2. REIT Spin-offs

In general, a corporation is required to recognize gain on the distribution of property (including the stock of a subsidiary) to its shareholders as if the corporation had sold the property for its fair market value,[16] and the shareholders receiving the property are generally treated as having received a taxable distribution.[17] Under section 355, however, there is no tax to a corporation (a distributing corporation) or its stockholders when the corporation distributes the stock of another corporation that it controls (a controlled corporation), if certain requirements are met.

Prior to the enactment of the PATH Act on Dec. 16, 2015, the IRS had issued a revenue ruling and several favorable private letter rulings that a spin-off involving a REIT could qualify under section 355.[18] Consequently, a C corporation that held assets suitable for a REIT could contribute those assets to a subsidiary that would elect REIT status after the spin-off and then distribute the subsidiary stock to its shareholders tax free. Following the spin-off, the REIT would generally be subject to corporate-level tax on any built-in gain assets it held at the time of the spin-off, if it disposed of them in a taxable transaction during the built-in gain recognition period.

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[15] *See* T.D. 9810 ("The Chairmen and Ranking Members also asked that the temporary regulations and the proposed regulations be modified to provide that REITs, RICs and S corporations are all subject to the same five-year built-in gain recognition period in order to be consistent with congressional intent and longstanding practice. The Treasury Department and the IRS… agree with the comment relating to the length of the recognition period. Accordingly, these final regulations provide that the term recognition period means the recognition period described in section 1374(d)(7).")

[16] Section 311(b).

[17] Section 301(c).

[18] *See, e.g.,* Rev. Rul. 2001- 29, 2001-1 C.B. 1348 (ruling that a REIT can satisfy the "active business" requirement of Section 355(b) through rental activities); Priv. Ltr. Rul. 201607003 (Nov. 5, 2015); Priv. Ltr. Rul. 201528006 (July 10, 2015); Priv. Ltr. Rul. 201411002 (Mar. 14, 2014); Priv. Ltr. Rul. 201407005 (Feb. 14, 2014) ; Priv. Ltr. Rul. 201337007 (Sep. 13, 2013); Priv. Ltr. Rul. 201340009 (Oct. 18, 2013).

a. The PATH Act

The PATH Act restricted REIT spin-offs in two respects. First, it amended section 856 to prohibit a C corporation that has engaged in a tax-free spin-off as either a distributing corporation or a controlled corporation (or such entity's "successor") from **electing** to be a REIT before the end of the 10-year period beginning on the date of the spin-off (the "REIT Election Lockout Period").[19] The clear statutory language of section 856(c)(8) applies only to REIT elections, not to C corporations merging into REITs in a section 381 transaction. Thus, the amendment to section 856 should 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 i) the REIT first elects to be a REIT in the REIT Election Lockout Period; and, ii) the REIT is treated as a successor of the C corporation.

Second, the PATH Act amended section 355 to restrict the ability of C corporations to participate in tax-free spin-offs if either the distributing corporation or the controlled corporation is a REIT.[20] 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).[21] The PATH Act also allows for a C corporation to elect REIT status and spin-off a controlled taxable REIT subsidiary (TRS) (that had been a TRS of the REIT for at least three years), provided that the spin-off occurs at least 3 years after the REIT conversion.[22]

b. The Automatic Deemed Sale Rule

The 2016 Regulations imposed, and the 2017 Regulations retain, significant additional restrictions on REIT spin-off transactions. First, the 2017 Regulations subject a C corporation to the Automatic Deemed Sale Rule if: i) the C corporation or any member of the C corporation's separate affiliated group (SAG), within the meaning of section 355(b)(3)(B), was the distributing corporation or controlled corporation in a spin-off; and, ii) the C corporation engages in a Conversion Transaction in the 20-year period that begins 10 years before the date of a spin-off (the Automatic Deemed Sale Period).[23] For this purpose,

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[19] Section 856(c)(8).
[20] Section 355(h)(1). This general rule does not apply if both the distributing corporation and the controlled corporation are REITs immediately after the distribution. Additionally, the PATH Act allows 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.
[21] Section 355(h)(1).
[22] Section 355(h)(2)(B).
[23] Prop. Reg. § 1.337(d)-7(f)(1) and Treas. Reg. § 1.337(d)-7T(c)(6). Technically, a REIT that participates in a spin-off within 10 years *after* a Conversion Transaction is not subject to the Automatic Deemed Sale Rule. Instead, the REIT's net recognized built-in gain in the year of the spin-off is the amount of its net unrealized built-in gain limitation, as defined in Treas. Reg. § 1.1374-2(a)(3). The effect, however, is practically the same as if the Automatic Deemed Sale Rule applied, insofar as the REIT is required to recognize any remaining gain that would otherwise be deferred under the section 1374 treatment rule. References herein to the "Automatic Deemed Sale Rule" accordingly refer to the treatment of a REIT that participates in a spin-off at any time in the Automatic Deemed Sale Period.

references to “controlled” and “distributing” corporations and members of the SAG include any predecessor or successor of such corporation.[24]

i. Scope of the Automatic Deemed Sale Rule

The 2019 Regulations limit the application of the Automatic Deemed Sale Rule to “distribution property,” which is generally defined as property owned immediately after by the spin-off by the C corporation or a member of the SAG of which the C corporation is the common parent (the Distribution Property Limitation).[25] Consequently, if a C corporation converts to, or transfers assets to, a REIT in the Automatic Deemed Sale Period, the 2019 Regulations would generally require the C corporation to recognize gain and (subject to limitations) loss as if it had sold all of its distribution property (rather than all of its property) at its fair market value immediately prior to the Conversion Transaction. A C corporation must generally establish that any built-in gain property is not distribution property.[26] Nareit appreciates the Treasury Department’s and IRS’ limitation of the over-inclusiveness of the 2016 Regulations’ original Automatic Deemed Sale Rule.

Despite this much-welcomed change to the scope of the Automatic Deemed Sale Rule, it remains very broad, particularly in the number of entities the actions of which may cause the rule to apply. For example, if a C corporation merges with and into a REIT, some or all of the C corporation’s assets may be subject to the Automatic Deemed sale if, in the 10 years preceding the merger, any of the following engaged in a tax-free spin-off:

- The corporation
- Any predecessor of the C corporation (*i.e.*, an entity from which the C acquired assets in a tax-free reorganization or a tax-free liquidation)
- Any member of the SAG of the corporation
- Any predecessor of any member of the SAG of the corporation

As described in greater detail below, assuming that the Automatic Deemed Sale Rule is retained, Nareit recommends that the scope of the rule be further narrowed in order to avoid penalizing a wide variety of every day, non-abusive transactions.

[24] Prop. Reg. § 1.337(d)-7(f)(2). The proposed regulations amended -7(f)(2) to clarify that the Automatic Deemed Sale Rule applies to successors and predecessors of members of a SAG.
[25] Prop. Reg. § 1.337(d)-7(a)(2)(viii)(A). Distribution property also includes property with a basis determined, directly or indirectly, by reference to such property. Prop. Reg. § 1.337(d)-7(a)(2)(viii)(B).
[26] Property with a built-in loss is presumed not to be distribution property unless the C corporation establishes otherwise. Prop. Reg. § 1.337(d)-7(c)(6)(ii).

ii. The Automatic Deemed Sale Period

The preamble to the 2016 Regulations stated the section 337(d) regulations were amended after the PATH Act to the address the concern that section 1374 treatment

> may not adequately implement the purposes of *General Utilities* repeal if a taxpayer effects a tax-free separation of REIT-qualifying assets from non-qualifying assets in a section 355 distribution (the related section 355 distribution) and the REIT-qualifying assets become the assets of a REIT. After such transactions, gain on the assets held by the REIT may not be taxed at the corporate level because such gain is unlikely to be recognized within the recognition period during which the REIT is subject to section 1374 treatment under the final regulations in Sec. 1.337(d)-7. In contrast, without a section 355 distribution, a taxpayer generally could not separate REIT-qualifying assets from non-qualifying assets and cause one corporation to hold the REIT-qualifying assets and another corporation to hold the non-qualifying assets except by means of a sale or exchange to which section 1001 applies or a distribution to which section 311(b) applies.

In other words, in the Treasury Department's view, a tax-free spin-off followed by the acquisition of the assets of the distributing or controlled corporation by a REIT would arguably allow taxpayers to remove assets from the corporate tax base in a manner inconsistent with *General Utilities* repeal and the limitations placed on section 355 by the PATH Act. As discussed in greater detail below, this view ignores that Congress created the section 1374 built-in gains tax to address this concern, and subsequently amended section 337(d) to extend section 1374 treatment to precisely this transaction—in which built-in gain assets move from a C corporation to a REIT in a carryover basis transaction.

c. The REIT-Only Spin-off Exception

As Nareit noted in its letter offering comments and recommendations to the 2016 Regulations, the 2016 Regulations effectively eliminated certain statutory exceptions to the PATH Act's prohibition on tax-free spin-off transactions.[27] In particular, the 2016 Regulations narrowed the scope of the REIT-Only Spin-Off Exception, and did so without articulating any policy rationale. The PATH Act permits tax-free REIT spin-offs so long as both the distributing corporation and the controlled corporation are REITs immediately after the distribution; the 2016 Regulations imposed 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.*[28] The 2019 Regulations have retained this two-year rule. 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 2019 Regulations, if

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[27] Letter from Tony M. Edwards, Exec. Vice President and Gen. Counsel, Nareit, to the IRS (July 16, 2016).
[28] See Treas. Reg. § 1.337(d)-7T(f)(3).

the controlled corporation were to fail to qualify as a REIT in the next two years – even inadvertently due to a technical failure of the REIT rules—both the distributing corporation and the controlled corporation would immediately be subject to the Automatic Deemed Sale Rule. It is ironic that the 2019 Regulations would impose a two-year "old and cold" requirement not found in the statutory language while these same regulations did not adopt the common sense two-year "old and cold" rule Nareit suggested in 2016 to incorporate in the Automatic Deemed Sales period.

B. Recommendations

1. Modify the Automatic Deemed Sale Rule so that it only applies when a Conversion Transaction occurs in the 10-year period beginning 5 years before a tax-free spin-off

As described above, the Automatic Deemed Sale Rule applies to many types of transactions that are not explicitly within the scope of the PATH Act, particularly spin-offs when both distributing and controlled are C corporations, and distributing or controlled merges with and into a REIT after the spin-off. The preamble to the 2019 Regulations acknowledges this fact in its observation that "the merger of Acquiring *[i.e.*, a successor to a C corporation that participated in a tax-free spin-off] into a REIT is not addressed by section 856(c)(8)."[29]

Nareit recognizes that, in certain circumstances, these transactions may run afoul of the purpose of the PATH Act and *General Utilities* repeal more generally, particularly when a spin-off and subsequent merger are completed as part of a plan. The 2016 Regulations and 2019 Regulations are intended to address this concern—that the section 1374 treatment

> may not adequately implement the purposes of *General Utilities* repeal if a taxpayer effects a tax-free separation of REIT-qualifying assets from non-qualifying assets in a section 355 distribution

[29] The Automatic Deemed Sale Rule generally applies two types of transactions: i) transactions in which a C corporation converts or merges with and into a REIT and then engages in a spin-off within 10 years (a Pre-Spin-Off Conversion Transaction;) and, ii) transactions in which a C corporation merges with and into a REIT after a spin-off (a Post-Spin-off Merger). (In practice, the Automatic Deemed Sale Rule will not apply to a conversion of a C corporation that has participated in a tax free spin-off, because such conversions are prohibited by section 856.) Section 856(c)(8) does not apply to either Pre--Spin-Off Conversion Transactions because it prohibits REIT elections only during the REIT Election Period, which begins on the date of a spin-off and extends 10 years. The statute does not contemplate or have any effect on REIT elections that occur *prior* to a spin-off. Section 856(c)(8) also does not apply to most Post-Spin-off Merger transactions, because a C corporation engaged (or treated as engaged) in a spin-off transaction does not make a REIT election. Nor does an existing REIT into which the C corporation might merge make a new REIT election. *See* section 856(c)(1) (an entity will not be subject to tax as a REIT unless "it files with its return for the taxable year an election to be a real estate investment trust or has made such election for a previous taxable year, and *such election has not been terminated or revoked under*.") *See also* the instructions to Form 1120-REIT ("The 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.").

(the related section 355 distribution) and the REIT-qualifying assets become the assets of a REIT.

In other words, the Automatic Deemed Sale Rule is intended to operate as an anti-abuse rule to prevent transactions that, while not explicitly within the scope of the PATH Act, "could be used to circumvent the Congressional policy implemented through section 311 of the PATH Act."[30]

As Nareit argued in its letter offering comments and recommendations to the 2016 Regulations, however, the Automatic Deemed Sale Rule is too blunt an instrument to backstop the purposes of the PATH Act and *General Utilities* repeal, particularly because it is an instrument not found in the PATH Act itself.[31] Furthermore, the Automatic Deemed Sale Rule is not needed to enforce section 337(d)'s goal of preventing avoidance of *General Utilities* repeal, because the assets that move from a post-spin-off C corporation to a REIT in a merger remain subject to section 1374's built-in gains tax regime for the full length of the recognition period. In other words, the Automatic Deemed Sale Rule does not advance any policy objective that is not already being advanced by the section 337(d) regulations as they existed prior to the issuance of the Automatic Deemed Sale Rule.

For example, if a controlled corporation merges with and into a REIT many years after a spin-off and the merger is not part of the plan with the spin-off, the purposes of PATH Act or *General Utilities* are not implicated, because the distributing corporation has not used the merger as a way to remove the controlled corporation's assets from the corporate tax base, and the assets of the controlled corporation remain subject to the built-in gains tax in the hands of the acquiring REIT. In such cases, Nareit believes that the general rules of section 1374 adequately enforces the doctrine of *General Utilities* repeal, because the controlled corporation is prevented from selling its assets within five years of the merger without entity-level tax.

The 10-year period appears to have been chosen so as to avoid any likelihood that the REIT election was part of a plan. That seems appropriate only when the corporation itself is involved. The transactions covered by the Automatic Deemed Sale Rule, however, necessarily involve separate parties and therefore much less likelihood of being part of a plan. As a result, it seems more reasonable to use a 5-

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[30] *See* the Preamble to the 2016 Regulations.

[31] Letter from Tony M. Edwards, Exec. Vice President and Gen. Counsel, Nareit, to the IRS (July 16, 2016) ("At 20 years, however, the 2016 Regulations' "blackout period" 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*.") Nareit proposed a 2-year presumption rule, under which any conversion transaction completed within 2 years after a spin-off transaction is presumed to be part of a plan with the spin-off transaction (and is subject to deemed sale treatment), and any conversion transaction not completed within that period is presumed not to be part of a plan with the spin-off transaction (and is not subject to deemed sale treatment).

year period for automatic deemed sales, especially since the converted assets will be subject to the 5-year recognition period under section 1374 after they are converted.[32]

As the 2017 Proposed Regulations confirmed, the enforcement mechanism of the regulations under section 337(d) are based on a 5-year gain recognition period made permanent by the PATH Act. Nareit believes that, in order for the Automatic Deemed Sale Rule to be consistent with the PATH Act, it should similarly apply for a five-year period. Nareit understands, however, that in the case of Conversion Transactions that may occur before or after a tax-free spin-off, it may be necessary for the Automatic Deemed Sale Rule to apply to the five-year periods both beginning and ending on the date of the spin-off. Accordingly, Nareit recommends that the Automatic Deemed Sale be modified so that it applies for the 10-year period beginning on the date that is 5 years before a tax-free spin-off.

2. **Do not apply the Automatic Deemed Sale Rule when a REIT that acquires property from a C corporation: i) receives a representation that the C corporation (along with specified predecessors and members of the affiliated group of which the C corporation is a member) has not engaged in a "related section 355 distribution," within the meaning of Prop. Reg. § 1.337(d)-7(f)(1); and, ii) has no actual knowledge contrary to such representation**

As described above, the Automatic Deemed Sale Rule would apply to spin-offs or conversion transactions regardless of whether they are abusive and run afoul of the purposes of the PATH Act and *General Utilities* repeal. As a result, the Automatic Deemed Sale Rule would add significant unnecessary risk and complexity to ordinary REIT M&A transactions without furthering any policy objective with respect to those transactions. Not only does would this undue complexity run counter to the directives of E.O. 13789, but this complexity would be compounded by the fact that the application of the Automatic Deemed Sale Rule to a C corporation could depend on whether any one of a number of entities have engaged in a spin-off transaction. The actions of an entity at several levels removed from the C corporation engaged in the Conversion Transaction could "infect" the C Corporation and cause the Automatic Deemed Sale Rule to apply.

For example, suppose that:

- C corporation (Corp A) owns 100% of the stock of a subsidiary C corporation (Sub 1).
- Sub 1 owns 100% of the stock of a subsidiary C corporation (Sub 2).
- In Year 1, Corp A spins off Sub 1 in a tax-free transaction under section 355.

[32] Other Code sections premised on the finding of a "plan" use a shorter standard. *See, e.g.*, section 355(e) ("4-year period beginning on the date which is 2 years before the date of the distribution") and Treas. Reg. § 1.707-3(c)(1) ("if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner . . ., the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale").

- In Year 5, Sub 2 merges with and into a C Corporation (Corp B) in a tax-free transaction under section 381.
- In Year 9, Corp B merges with and into a REIT.

The Automatic Deemed Sale Rule would apply to the merger of Corp B into the REIT because a C corporation (Corp B) would have engaged in a Conversion Transaction and, in the ten-year period prior to the Conversion Transaction, a predecessor of the C corporation (Sub 2) was the member of the SAG of a corporation that engaged in a tax-free spin-off (Sub 1).

This viral nature of the Automatic Deemed Sale Rule raises two issues: first, it may severely limit the usefulness of the Distribution Property Limitation. In the example described above, the Automatic Deemed Sale would apply to Corp B upon its merger with and into a REIT when, in the ten-year period prior to the merger, a predecessor of C Corp B (Sub 2) was the member of the SAG of a Sub 1, which engaged in a tax-free spin-off 8 years prior (Sub 1). The Automatic Deemed Sale Rule would require Corp B to recognize all of the built-in gain in its assets at the time of the merger with the REIT, unless Corp B could establish that certain of its assets were not distribution property. Given that the offending spin-off occurred 8 years prior and involved neither Corp B nor any entity which it directly acquired or owned at any time, it could be difficult for the REIT to rebut the presumption with respect to any particular property acquired from Corp B. As a result, although the 2019 Regulations are intended to impose tax on built-in gain in assets that were part of the spin-off transaction—in this example, perhaps zero—the practical complexities of the Automatic Deemed Sale Rule could effectively impose tax on other assets.

Second, the viral nature of the Automatic Deemed Sale Rule could create an insurmountable due diligence problem, both from the perspective of determining whether a target has been tainted by the spin-off of a predecessor and, if it has, from the perspective of determining what property of the target is distribution property. Because a C corporation may be subject to the Automatic Deemed Sale Rule if it or a member of its SAG, or any predecessor or successor thereof participated in a spin-off, an entity engaging in a Conversion Transaction with the C corporation would have to diligence every entity in what may be a very long chain connected by SAGs and section 381 transactions (*i.e.*, successors and predecessor).[33] Given the volume of section 381 transactions in the C corporation space, this viral nature of the Automatic Deemed Sale Rule could, especially in the public company context, create an insurmountable tax due diligence problem. Often, it would be impossible to reach a level certainty sufficient to proceed with a transaction.

[33] 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.

Nareit understands that the 2016 Regulations and 2019 Regulations are motivated in part out of a "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."[34] Nareit believes, however, that it is possible to preserve the policy aims of the Automatic Deemed Sale Rule but prevent its breadth from imposing insurmountable burdens on participants in non-abusive merger and acquisition activity. Nareit believes that striking this balance is particularly important in light of: i) E.O. 13789; ii) the complexity and cost that the Automatic Deemed Sale Rule would add to ordinary REIT M&A transactions; and, iii) the fact that the Automatic Deemed Sale Rule is not explicitly provided for by the PATH Act.

Accordingly, Nareit respectfully suggests that the 2019 Regulations adopt a knowledge standard as part of the Automatic Deemed Sale Rule. Pursuant to this standard, the Automatic Deemed Sale Rule would not apply to Conversion Transactions when a REIT that acquires property from a C corporation: i) receives a representation that the C corporation is not a corporation referred to in Prop. Reg. § 1.337(d)-7(f)(1) (*i.e.*, it is not treated as having engaged in a spin-off transaction, including by reason of a successor, predecessor, or SAG member; and, ii) has no actual knowledge contrary to such representation. The representation would have to be made by the seller (or sellers) of the C corporation or by the C corporation itself, and it could be made to the best of the representing party's knowledge.

This approach is not a perfect solution—it would not prevent the Automatic Deemed Sale Rule from applying to certain transactions that Nareit believes are non-abusive, such as a spin-off followed by a merger four years later (not pursuant to a plan) of the controlled corporation in a REIT. But it would allow parties that have no knowledge of prior spin-off transactions by predecessors or SAG members to transact with relative certainty about their tax positions and without an insurmountable diligence burden. Additionally, because section 1374 would still apply to the conversion transaction, the parties to the transaction would still be prevented from circumventing the policies of *General Utilities* repeal.

A knowledge standard is particularly appropriate to REIT M&A, because REITs must undertake extensive due diligence in any merger with a C corporation to be certain that the transaction does not cause the REIT to lose its REIT status. For example, a REIT merging with a C corporation must generally conduct an E&P study of the C corporation in order to ensure that the REIT complies with the requirement that it distribute all C corporation earnings and profits to which the REIT succeeds under section 381 pursuant to section 857(a)(2)(B). This study will necessarily entail extensive due diligence into the earnings and profits of both the target C corporation and any other C corporation acquired by the target in a prior section 381 transaction. Any prior spin-offs or mergers in which the C corporation has engaged that are not uncovered through this diligence cannot, by definition, be part of an abusive plan together with the merger.

[34] Preamble to the 2016 Regulations.

Nareit acknowledges that the PATH Act does not expressly provide for a knowledge standard. The statutory basis of the Automatic Deemed Sale Rule itself, however, also is not found in the PATH Act, but in section 337(d), which directs the Secretary of the Treasury to prescribe regulations that are necessary or appropriate to carry out the purposes of *General Utilities* repeal. Furthermore, the Treasury Department has issued regulations implementing a knowledge standard in several instances in which it has general authority to issue regulations to prevent avoidance or carry out the purposes of a statutory provision.

For example, section 355(d) generally requires a distributing corporation in a spin-off to recognize gain on distributions that would otherwise qualify as tax-free under section 355, if: 1) a shareholder holds a 50%-or-greater interest (determined by vote or value) in either the distributing or controlled corporation immediately after the distribution; and, 2) that interest is attributable to stock of the distributing corporation that was purchased within the five-year period ending on the date of the distribution. Section 355(d)(9) generally grants the Secretary of the Treasury authority to "prescribe such regulations as may be necessary to carry out the purposes of [section 355(d)]." Treas. Reg. §1.355-6(f)(1) provides that "[i]n determining whether section 355(d) applies to a distribution of controlled corporation stock, a distributing corporation must determine whether a disqualified person holds its stock or the stock of any distributed controlled corporation." In making this determination, the corporation is entitled, absent actual knowledge to the contrary, to: i) presume that every shareholder required to file a document under SEC rules regarding such shareholder's ownership; and, ii) rely on such document as accurate and complete.

Comparable provisions appear to have been implemented by regulations when statutory text provided the IRS had general authority to issue regulations to prevent avoidance or carry out the purposes of the relevant statutory provision, but such text provided no specific guidance about a knowledge standard. For example, Treas. Reg. § 1.355-7(h)(8), which is issued pursuant to section 355(e)(5)'s grant of authority to the Secretary of the Treasury to prescribe "such regulations as may be necessary to carry out the purposes of [section 355(e)." Treas. Reg. § 1.355-7(h)(8) entitles a corporation, absent actual knowledge to the contrary, to rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its five-percent shareholders.

Similarly, section 163(f)(1) limits interest deductibility on certain registration-required obligations that are not in registered form. Prior to amendment by the Hiring Incentives to Restore Employment Act in 2010,[35] section 163(f)(2)(B) provided that foreign-targeted bearer bonds were exempt from registration so long as: i) there were arrangements reasonably designed to ensure they would be sold only to a non-U.S. person; (ii) interest was payable only outside the U.S.; and, iii) there was a statement on the face of the obligations indicating that any U.S. person who holds the obligations would be subject to U.S. income tax laws.

[35] P.L. 111-147.

Although not specifically required by statutory text, then-applicable Treas. Reg. § 1.163-5(c) imposed certain conditions in order to demonstrate that there were arrangements reasonably designed to ensure an obligation would be sold only to a non-U.S. person, including under Treas. Reg. § 1.163-5(c)(2)(i)(B)(4), the presentation of a certificate of non-U.S. ownership. Significantly, Treas. Reg. § 1.163-5(c)(2)(i)(B)(5) permitted the reliance on this certificate so long as the issuer and others have no actual knowledge that the certificate of non-U.S. ownership is false.

Nareit suggests that the knowledge standard could be implemented similarly to the non-United States real property holding corporation status certificate procedures of Section 1445 and Treasury Regulations Section 1.1445-5(b)(4)(iii). The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) generally provides that gain recognized by non-U.S. persons from the sale or exchange of United States real property interests (USRPIs) is subject to tax as if the non-U.S. person were engaged in a trade or business within the United States during the taxable year of the sale or exchange and such gain or loss were effectively connected with such trade or business.[36] Section 1445 provides a withholding regime that backstops FIRPTA—a seller of a USRPI to a foreign person is generally required to withhold 15% of the purchase price.

A USRPI includes any interest (other than an interest solely as a creditor) in any domestic corporation unless such corporation was at no time a United States real property holding corporation ("USRPHC") in the five-year period preceding the date of testing (or in the time since the corporation's formation, if shorter). A USRPHC is generally any corporation if the fair market value of its USRPIs equals or exceeds 50% of the aggregate value of its USRPIs, its interest in real property located outside the United States, and any other of its assets that are used or held for use in a trade or business. Whether a corporation is a USRPHC (and its disposition is subject to withholding) is thus a highly fact-intensive determination, with high stakes. Without a knowledge standard, a purchaser of any corporation from a foreign person would either have to (i) conduct sufficient diligence of the composition of the corporation's assets at all times in the previous 5 years or (ii) withhold 15% of the purchase price. In order to avoid burdening standard M&A transactions with this choice, Treas. Reg. § 1.1445-5(b)(4)(iii) allows purchasers to rely on a certification by the corporation that it is not a USRPHC, absent actual knowledge to the contrary.[37]

[36] Section 897(a).

[37] Nareit acknowledges that, unlike the PATH Act, section 1445(b) explicitly provides for a knowledge standard. We do not cite Treas. Reg. § 1.1445-5(b)(4)(iii) as evidence that Treasury has the authority to issue such a standard, but merely as an example of a workable framework.

3. Modify the Automatic Deemed Sale Rule so that it would 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

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 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. The 2019 Regulations, following the 2016 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 to broaden the scope of the PATH Act in a manner that was not intended by Congress.

The 2016 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-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 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 (e.g. through an inadvertent mistake), both the controlled corporation and the distributing corporation would suffer potentially catastrophic adverse tax consequences under the Automatic Deemed Sale Rule. A REIT may be unwilling to spin-off a subsidiary REIT in light of the magnitude of the potential downside, despite the fact that Congress clearly intended to provide an exception to the PATH Act for REIT spin-offs of other REITs. Accordingly, Nareit believes that the 2019 Regulations' narrowing of the REIT-Only Spin-Off Exception runs counter to Congress's intent and should not be included in the final regulations.

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Thank you again for the opportunity to submit these comments. Feel free to contact me at tedwards@nareit.com, Catherine Barré, Nareit's EVP and General Counsel, at cbarre@nareit.com, or Dara Bernstein, Nareit's Senior Vice President & Tax Counsel, at dbernstein@nareit.com to discuss these issues in greater detail.

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