Real estate
working for you

Feb. 27, 2020

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
1500 Pennsylvania Avenue, N.W.
Room 3120MT
Washington, D.C. 20220

Re: Double Downward Attribution and the REIT Related Party Rent Rules

Dear Mr. Kautter:

Nareit[1] would like to raise a tax issue that is increasingly creating barriers for real estate investment trusts (REITs) that are considering raising capital from others or providing capital to certain tenants.

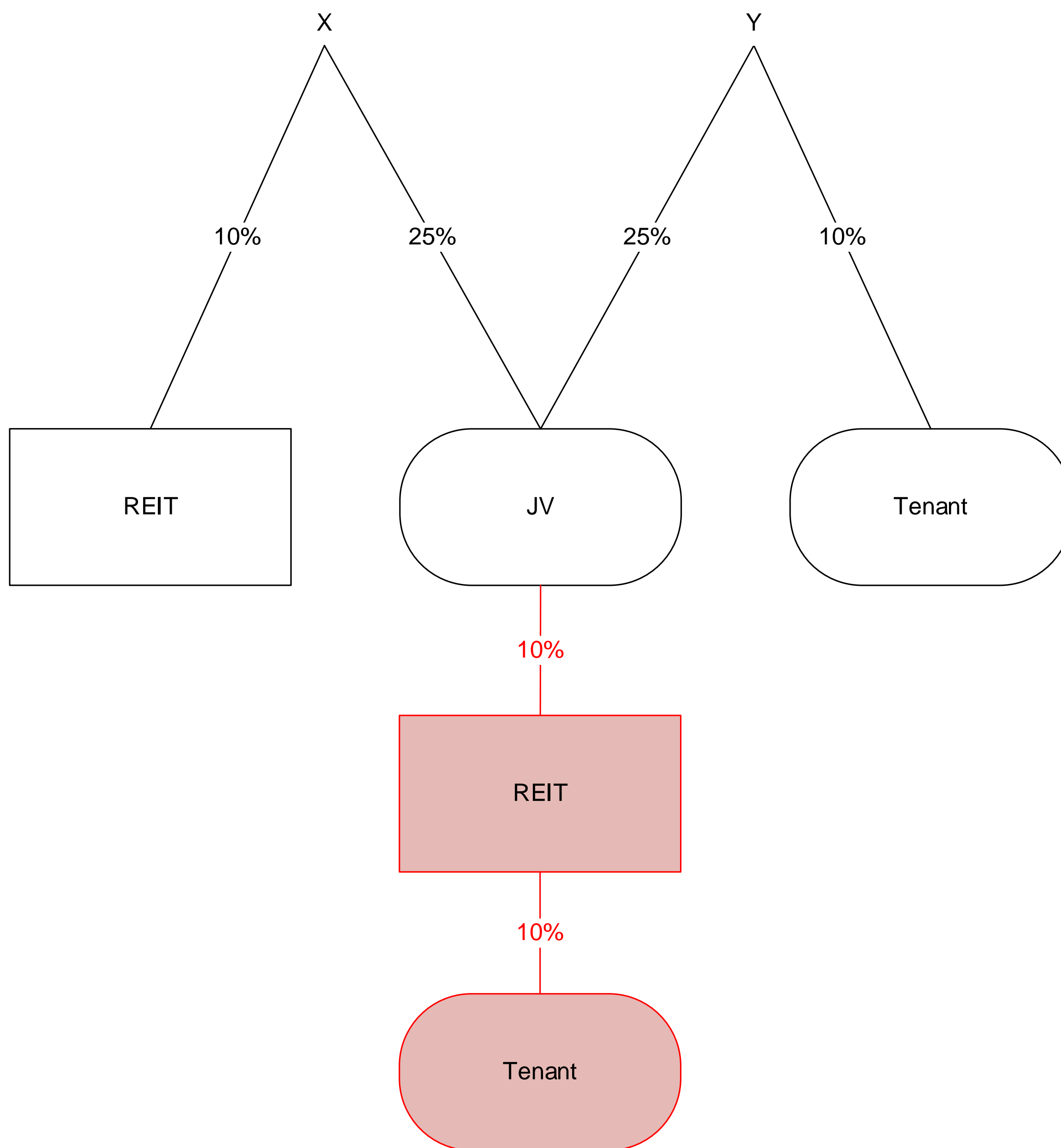
Related party rent tests under the REIT rules

Under the related party rent rules of section 856(d)(2)(B),[2] any payments a REIT receives from an entity in which the REIT owns 10% or more of its equity is not considered qualified rents under the REIT income test rules. The 10% test is often impossible to apply or enforce because of "double downward" constructive ownership rules that require a REIT to examine not only its own holdings, but also the holdings of its 10% or more stockholders, their 10% stockholders, and then pooling such holdings in other vehicles (often unrelated joint ventures) and then applying the attribution rules again so that the pooled holdings then own each other. This pooling and reattribution, if the attribution rules are followed literally, can result in rent disqualification, which is not intended by the related party rent rules. The issue might be best illustrated by the diagram on the next page:

[1] Nareit is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. Nareit advocates for REIT-based real estate investment with policymakers and the global investment community. Through the properties they own, finance and operate, REITs help provide the essential real estate we need to live, work and play. All U.S. REITs own approximately $3 trillion in gross assets, public U.S. REITs account for $2 trillion in gross assets, and stock-exchange listed REITs have an equity market capitalization of over $1 trillion. In addition, more than 80 million Americans invest in REIT stocks through their 401(k) and other investment funds.
[2] Unless otherwise noted, references to "section" in this letter refer to sections of the Internal Revenue Code of 1986, as amended (the Code).

1875 I Street, NW, Ste 500
Washington, D.C. 20006-5413
202-739-9400

reit.com



(1) JV owns 10% of REIT directly by downward attribution from X.
(2) JV owns 10% of Tenant by downward attribution from Y.
(3) REIT owns what JV owns in tenant via "double downward" attribution from JV.
(4) REIT owns 10% of Tenant.
(5) Elimination of double downward attribution would cure related-party rent.

These rules were written many years ago (1960) and need to be modernized to reflect the way REITs currently raise capital and operate properties. The related party rent rules cause the unintended consequence of disqualifying rent in non-abusive situations including those where the REIT has no control over, and perhaps no economic interest in, the "related" party. These rules impose substantial limitations on a REIT's ability to raise capital in the public markets and through joint ventures, compete with entities that rent wholesale and sublease retail as well as its ability to support tenants in this challenging retail market and thus preserves jobs.

Consequences of these 1960 artifacts

Given the growth and increasing concentration of investment partnerships by institutional investors such as pension plans and investment partnerships, it has become increasingly difficult if not impossible to determine if the REIT related party rent rules are being violated.

In addition, the current related party rent rules can cause rent from a tenant of a REIT at one property to be disqualified when an investor in that REIT is in a joint venture with respect to a different property with the owner of that tenant. Given the prevalence of joint venture financing in today's real estate market, it makes little sense to consider the ownership by a partner's partner in determining related party rent. To illustrate: Investor A owns more than 10% of a REIT (which owns property in New York) and 50% of a joint venture (which owns property in San Francisco) with Investor B (who owns the other 50%). If Investor B owns more than 10% of a tenant of the New York property, the rent from the NY tenant is disqualified even though the REIT and Investor B have no economic relationship. This unintended consequence is caused by the technical application of so-called "double downward" attribution. This double downward attribution, and the low threshold for attribution in general, present material restrictions on the ability of a REIT to raise capital through joint ventures. Eliminating "double downward attribution" for purposes of Section 856(d) would solve this problem.

Requested regulatory solution

The Treasury Department recently confronted similar challenges in implementing the controlled foreign corporation provisions following the 2017 tax reform legislation and effectively “turned off” double downward attribution rules applicable to these provisions for certain purposes.[3] We are asking the Treasury Department to issue comparable regulatory guidance solely with regard to the REIT related party rent rules.

---

[3] Prop. Treas. Reg. § 1.958-2(d)(1), (e), and (h). Cf. Nettie Miller, 43 T.C.760 (1965) when the court refused to apply the ownership attribution rules in the case of foreign personal holding company which would have resulted in clearly an absurd result and stated that the regs “should not be interpreted to produce absurd consequences even though such an interpretation might be within the literal language of the act.”

There are at least two sources of authority and precedents for the Treasury Department to issue the requested guidance.

First, section 856 provides blanket authority for turning off section 318. Paragraphs (2) and (3) of section 856(c) provide the two gross income tests a REIT must meet to maintain qualification as a REIT. However, section 856(c)(5)(J) states "To the extent necessary to carry out the purposes of this part, the Secretary is authorized to determine, solely for purposes of this part, whether any item of income or gain which— (i) does not otherwise qualify under paragraph (2) or (3) may be considered as not constituting gross income for purposes of paragraphs (2) or (3), or (ii) otherwise constitutes gross income not qualifying under paragraph (2) or (3) may be considered as gross income which qualifies under paragraph (2) or (3)." As a result, the IRS has the authority to make determinations regarding whether items of gross income that are not otherwise explicitly qualifying income under the statutory description of items of income under section 856 should, nevertheless, be treated as qualifying income. The IRS has exercised this authority on numerous occasions where treating the income attributable to the item in question as qualifying income does not "interfere with or impede the objectives of Congress in enacting" section 856(c)(2) and (3) (e.g., PLR 201929014 (April 12, 2019)).

As an example, the IRS issued Rev. Proc. 2018-48 which, among other things, allows a REIT to treat certain amounts required to be included in gross income by a REIT under section 951(a)(1) or 1296(a) as qualifying income for purposes of section 856(c)(2) pursuant to the authority granted to it under section 856(c)(5)(J)(ii).

In using its authority to determine whether certain items of income qualify under section 856, the IRS is not constrained by the attribution rules under 318.

Second, there exists an extensive list of examples in which the IRS has forgone a literal interpretation of section 318 where such an interpretation leads to unreasonable or inappropriate results. First, this can be seen in the section 318 regulations themselves. Treas. Reg.§ 1.318-1(b)(1) provides that an issuer shall not be considered to own its own stock notwithstanding section 318(a)(3)(C), which states that "If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person." The regulation is a clear example of where it refused to adopt a literal reading of the statute.

Additionally, Treas. Reg. § 1.318-1(b)(2) provides: "In any case in which an amount of stock owned by any person may be included in the computation more than one time, such stock shall be included only once, in the manner in which it will impute to the person concerned the largest total stock ownership." There is nothing in the literal language of section 318 itself that precludes this type of constructive

ownership, which shows that the regulations interpret section 318 to avoid a result that is inconsistent with the purpose of 318.

Similarly, Treas. Reg. § 1.318-1(b)(3) provides that "in determining the 50% percent requirement of Section 318(a)(2)(C) and (3)(C)[4] all of the stock owned actually and constructively by the person concerned shall be aggregated." For various reasons, Treas. Reg. §. 1.318-1(b)(3) appears to require both actual and constructive ownership for purposes of applying the 50% requirement, so that attribution would not occur solely due to constructive ownership when this is no actual ownership, because the regulation is written in the conjunctive rather than the disjunctive. Accordingly, Treas. Reg.§ 1.318-1(b)(3) seems to preclude attribution when there is no actual or economic interest in a corporation and prevents an inappropriate outcome from the mechanical operation of section 318(a)(2)(C) and (3)(C).

Revenue rulings provide additional examples of instances in which the IRS has rejected a literal reading of the statute. In Revenue Ruling 74-605, the IRS concluded that the literal applications of the rules must give way to the prohibition on an entity being treated as owning stock in itself and, importantly, this ruling has been adhered to for 45 years without change and has been applied a number of times over the years to characterize an upstream sale of stock as a section 1001 transaction. Revenue Ruling 69-562 also rejects a literal interpretation of section 318 and concludes that a corporation may not be treated as owning its own stock by virtue of owning on option to acquire its shares through application of section 318(a)(4), despite the statute providing that "[i]f any person has an option to acquire stock, such stock shall be considered as owned by such person" and that Treas. Reg. § 1.318-1(b)(1) only precludes a corporation from owning its own stock by virtue of section 318(a)(3)(C).

Finally, several IRS Private Letter Rulings provide additional support. In PLR 9205030 (Nov. 5, 1991), the IRS rejected a literal application of the option attribution rule under section 544(a)(3), which is identical to section 318(a)(4), and applied Revenue Ruling 69-562 to conclude that a REIT was not considered to own its own shares with respect to which it held an option for purposes of applying the REIT ownership test to section 856(h). And in PLR 201419013 (Nov. 22, 2013), the IRS dismissed an attempt to treat constructively owned stock as owned by two related shareholders for purposes of the "D" reorganization control test.

The above examples are consistent with the idea that section 318 only applies when there is some economic ownership interest that justifies application of the attribution rules. For example, Treas. Reg.§ 1.318-1(b)(1), Revenue Ruling 74-605, Revenue Ruling 69-562, and PLR 9205030 all reject a literal interpretation of section 318 that would cause a corporation to own shares in itself because it is absurd to treat a corporation as having an economic interest in itself. Treas. Reg § 1.318-1(b)(2) and (b)(3) each reject a literal reading of section 318 to the extent it would result in counting stock more than once, or

[4] Section 318(a)(2)(C) and (3)(C) both provide for attribution (to or from a shareholder of a corporation) if that shareholder directly or indirectly owns 50% or more of the value of the stock of that corporation.

Real estate
working for you

result in attribution solely due to constructive stock ownership without any actual stock ownership, as these results are inconsistent with the actual common economic relationship that exists between relevant parties.

We request a meeting to discuss this issue with you and your colleagues at the earliest opportunity. Please contact me at tedwards@nareit.com or (202) 739-9408; Cathy Barre, Nareit's Executive Vice President & General Counsel at cbarre@nareit.com or (202) 739-9422; or Dara Bernstein, Nareit's Senior Vice President & Tax Counsel at dbernstein@nareit.com or (202) 739-9446, if you have any questions.

Respectfully submitted,

Tony M. Edwards
Senior Executive Vice President

Cc:
The Honorable Michael J. Desmond
Andrea Hoffenson, Esq.
Helen Hubbard, Esq.
Michael S. Novey, Esq.
William M. Paul, Esq.
Krishna Vallabhaneni, Esq.
Brett York, Esq.