NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 13, 2012

VIA ELECTRONIC SUBMISSION http://www.Regulations.gov (IRS REG–139991–08)]

Courier's Desk
Internal Revenue Service,
CC:PA:LPD:PR (REG–139991–08)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Notice of Proposed Rulemaking: Certain Transfers of Property to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) (the 2012 Proposed Regulations)

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity to thank the Treasury Department and Internal Revenue Service for issuing the 2012 Proposed Regulations (REG-139991-08) relating to conversions of entities from, and transfers of assets by, C corporations[1] to REITs or RICs[2] under section 337(c) of the Internal Revenue Code of 1986 as amended[3], and to offer our suggestions with respect to these regulations. 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.

As further described below, the final regulations issued under section 337(d) in 2003 (the 2003 Regulations) generally provide that, when a REIT disposes of appreciated property within 10 years after acquisition from a C corporation in a "conversion transaction," the REIT must apply the rules of section 1374 and pay tax at the corporate level on any built-in gain except to the extent that the C corporation either recognizes gain on the transaction or elects "deemed sale" treatment to recognize and pay tax on the gain from the transaction (the 2003 Deemed Sale Rule).

[1] 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 non-REIT and non-RIC C corporations.
[2] Although the 2012 Proposed Regulations address both REITs and RICs, this submission will address only REITs.
[3] The Code. Unless otherwise provided, any reference to a "section" herein shall be to a section of the Code.

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The 2012 Proposed Regulations would modify the 2003 Regulations to exclude two types of conversion transactions from the 2003 Deemed Sale Rule. First, the 2012 Proposed Regulations would exclude a tax-exempt entity from the definition of a C corporation to the extent it would not be subject to tax on gain on the sale of the transferred property. Thus, a transfer of appreciated property from a tax-exempt entity to a REIT generally would not be a "conversion transaction." Second, the 2012 Proposed Regulations would exclude from the application of the 2003 Deemed Sale Rule a conversion transaction to the extent that the C corporation's gain is not recognized by reason of section 1031 or 1033.

EXECUTIVE SUMMARY

NAREIT appreciates the issuance of the 2012 Proposed Regulations, and urges the Treasury Department and IRS to finalize them as soon as possible, after taking into account the recommendations set forth below.

NAREIT recommends that when finalized, the 2012 Proposed Regulations clarify that, as further described below, a tax-exempt entity is excluded from the definition of a C corporation **to the extent** that it would not be subject to gain if it were to make a deemed sale election (not merely if it would be subject to any gain on such sale, however insignificant that gain might be). Further, recognizing that both simultaneous and deferred section 1031 exchanges are "section 1031(a) exchanges", NAREIT suggests that, when finalized, the 2012 Proposed Regulations clarify, by way of an example, that "reverse" section 1031 exchanges are excluded from the 2003 Deemed Sale Rule. Finally, NAREIT recommends that the preamble to the final regulations be clarified so that, for purposes of defining "conversion transaction," the term "transfer" in the final regulations not include the acquisition of appreciated property from a C corporation by a REIT if, immediately after acquisition, the REIT's basis is equal to the amount paid for the property (*e.g.*, a sale by the C corporation for cash to the REIT) other than a transaction falling under the gift sale rules. As a result, the disposition of appreciated property by a REIT within 10 years of its acquisition from a C corporation for cash or other consideration paid in an arm's length transaction would not be subject to the 2003 Deemed Sale Rule.

DISCUSSION

A. <u>Background</u>

1. *2003 Regulations*

In 2003, the Treasury Department and IRS issued the 2003 Regulations concerning transfers of appreciated property from C corporations to REITs under section 337(d). Section 337(d) authorizes the issuance of regulations to prevent circumvention of the repeal of the *General Utilities* doctrine; it is meant to ensure two levels of tax on income and gains of C corporations. Generally speaking, pursuant to the 2003 Deemed Sale Rule, the 2003 Regulations provide that, if property of a C corporation that is not a REIT becomes property of a REIT through a "conversion transaction" (which is generally a "transfer" of property from a C corporation to a REIT), the REIT generally must apply the rules of section 1374 and thereby recognize gain if it sells the property within 10 years after acquisition unless the C corporation elects "deemed sale" treatment. Electing deemed sales treatment would require the C corporation to recognize gain and loss as though it sold the property converted to REIT property or transferred such property to the REIT at fair market value immediately before the conversion transaction. Under section 1.337(d)-7(d)(1) of the 2003 Regulations, the 2003 Deemed Sale Rule does not apply "to the extent that gain or loss otherwise is recognized on such conversion transaction. See, for example, sections 336, 351(b), 351(e), 356, 357(c), 367, 368(a)(2)(F), and 1001." Notably, the 2003 Regulations do not include sections 1031 and 1033 as sections to which the 2003 Deemed Sale Rule does not apply.

The 2003 Regulations work well in most situations. However, they do result in outcomes inconsistent with circumvention of the repeal of *General Utilities* in two situations that were noted by the Tax Section of the American Bar Association (Tax Section) in its May 1, 2008 letter (Tax Section Letter) to the Internal Revenue Service. NAREIT echoed the Tax Section's comments in submissions dated June 3, 2008 (with The Real Estate Roundtable); May 28, 2009; June 10, 2010; May 26, 2011; and, May 1, 2012.

The Tax Section Letter noted that when either a C corporation transfers appreciated property to a REIT in a like-kind transaction or a tax-exempt entity transfers appreciated property to a REIT, there is no potential to circumvent *General Utilities* repeal. In the case of the like-kind transaction, the C corporation transferor acquires replacement property with a carried over basis; thus, it remains subject to tax on the built-in gain. In the case of a tax-exempt transferor, because the transferor is not subject to tax, it cannot be said to be avoiding recognition of built-in gain. The Tax Section Letter suggested an exemption from the 2003 Deemed Sale Rule applicable to the situations when either a C corporation transfers appreciated property to a REIT in a like-kind transaction[4] or a tax-exempt corporation transfers property to a REIT except to the extent that the tax-exempt corporation would be subject to tax upon a sale of the converted property.

2. *2012 Proposed Regulations Issued*

NAREIT is pleased that on April 13, 2012, the IRS issued the 2012 Proposed Regulations, which generally provide that: 1) the 2003 Deemed Sale Rule would not apply to transfers of property by a C corporation to a REIT to the extent that the transfer qualifies for non-recognition treatment under either section 1031 or 1033; and, 2) transfers of property by a tax-exempt entity (or by a partnership to a REIT to the extent of a tax-exempt partner's distributive share of the gain in the transferred property) would not be subject to the 2003 Deemed Sale Rule unless the tax-exempt entity would have been subject to tax if a deemed sale election had been made.

[4] Specifically, the Tax Section Letter stated "[w]e recommend that transactions involving exchanged basis property be excluded from the definition of a conversion transaction. This result could be readily achieved by defining "conversion transactions" in a manner similar to Regulation section 1.337(d)-7(a)(2)(ii), but excluding transactions where the C corporation receives "exchanged basis property" (as defined under section 7701(a)(44)) in connection with the transaction.)"

Specifically, Prop. Treas. Reg. § 1.337-7(d)(1) of the 2012 Proposed Regulations would continue to exempt a transfer of property from a C corporation to a REIT from the Deemed Sale Rule to the extent that gain is otherwise recognized by the transferring C corporation. Notably, Prop. Treas. Reg. § 1.337-7(d)(1) proposes now to include sections 1031 and 1033 in the list of sections pursuant to which gain might be recognized by such C corporation.

The 2012 Proposed Regulations also include a new section 1.337-7(d)(3), which proposes to exempt from the 2003 Deemed Sale Rule a transfer **to the extent** that "a C corporation transfers property with a built-in gain to a … REIT and the C corporation's gain is not recognized by real of either section 1031 or 1033". In fact, Example 3 in the 2012 Proposed Regulations details the transfer of appreciated property from a C corporation to a REIT in exchange for property and cash, in a transaction governed by section 1031(b). As a result, the C corporation recognizes some gain on the transaction, and realizes, but does not recognize, additional gain due to the application of section 1031. The example concludes that the 2003 Deemed Sale Rule will not apply to the extent that the C corporation transferor recognizes gain on the transaction (due to the application of Treas. Reg. § 1.337(d)-7(d)(1) (2003 Deemed Rule does not apply to the extent gain is recognized)) and to the extent that the C corporation realizes, but does not recognize, gain pursuant to application of section 1031.

On the other hand, the 2012 Proposed Regulations are not clear regarding whether a transfer by a tax-exempt entity of appreciated property to a REIT is exempt from the 2003 Deemed Sale Rule **to the extent** that the tax-exempt entity would not be subject to tax with respect to gain from a deemed sale election or **only if the tax-exempt entity would not be subject to tax at all** on any gain resulting from a deemed sale election.

The preamble to the 2012 Proposed Regulations appears to take the former approach:

Treasury and the IRS believe that the inclusion of direct or indirect transfers by tax-exempt entities in the scope of the final regulations furthers the purposes of *General Utilities* repeal only **to the extent** that those entities would have been subject to tax had a deemed sale election been made (for example, if a deemed sale election would have generated unrelated business taxable income or would have adversely affected the entity's tax-exempt status). Accordingly, the proposed regulations would amend the final regulations to provide that the definition of a C corporation excludes tax-exempt entities within the meaning of §1.337(d)-4(c)(2). As a result, transfers of property by a tax-exempt entity to a RIC or REIT (or by a partnership to a RIC or REIT to the extent of a tax-exempt partner's distributive share of the gain in the transferred property) generally will not be subject to section 1374 treatment. For this purpose, however, an entity will not be considered to be tax-exempt **to the extent** it would be subject to tax … with respect to gain (if any) resulting from a deemed sale election if such an election were made under §1.337(d)-7(c)(5) with respect to the transfer. [Emphasis added].

However, the text of Prop. Treas. Reg. § 1.337(d)-7(a)(iv)(B) does not conform to the preamble, because it states that a tax-exempt entity will not be treated as a C corporation (the transfer of appreciated property to a REIT from which would trigger application of the 2003 Deemed Sale

Rule) only if it "would not be subject to tax under Title 26 of the … Code with respect to gain (if any) resulting from a deemed sale election if such an election were made … with respect to the conversion transaction." The words "to the extent" are missing from the actual text of the Prop. Treas. Reg. § 1.337-7(a)(2)(vi)(B).

B. Recommendations

NAREIT appreciates the IRS' issuance of the 2012 Proposed Regulations, and encourages the IRS to finalize them as soon as possible, after taking into account the following recommendations.

1. *Treat a Tax-Exempt Entity as a C Corporation **to the Extent** that It Would Be Subject to Gain if It Makes a Deemed Sale Election*

We recommend that the text of the 2012 Proposed Regulations be conformed to its preamble to exclude a tax-exempt entity from the definition of a C corporation **to the extent** that it would not be subject to tax on its gain (or its distributive share of partnership gain if it (or a partnership of which it were a partner) were to make a deemed sale election.[5]

2. *Amend the Final Regulation's Preamble to Reflect Exclusion from 2003 Deemed Sale Rule of Reverse Section 1031Exchanges*

Because a number of section 1031 exchanges are effected by means of a deferred exchange (using an intermediary), including reverse like-kind exchanges under Rev. Proc. 2000-37, 2000-2 C. B. 308, we recommend that the 2012 Proposed Regulations be supplemented by a statement in the preamble or, preferably, by a specific example in the final regulations, so that it is clear that the final regulations apply not only to simultaneous and deferred section 1031 and 1033 exchanges, but also to reverse like-kind exchanges under Rev. Proc. 2000-37.

3. *Correct Error in Prop. Treas. Reg. § 1.337(d)(1)*

The reference in Prop. Treas. Reg. § 1.337(d)-7(d)(1) should be to section 1033(a), not section 1033(b).

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[5] As footnote 20 of the Tax Section Letter noted:

> If a tax-exempt corporation that is a qualified organization within the meaning of section 514(c)(9)(C) (*e.g.*, a section 501(c)(25) organization that is classified as a corporation) disposes of real property that is subject to "acquisition indebtedness," gain from that sale will be exempt from tax so long as none of the exceptions in section 514(c)(9)(B) apply. Where a partnership has tax-exempt corporate partners that are qualified organizations, a disposition by the partnership of real property subject to such acquisition indebtedness would not give rise to gain that would be taxable to the qualifying organizations so long as the partnership meets one of the requirements set forth in section 514(c)(9)(B)(vi). In most cases, the partnership will avoid subjecting its qualifying organization partners to tax by satisfying the "fractions rule," as described in section 514(c)(9)(E) and Reg. §1.514(c)-2.

4. *Exclude from the Definition of "Transfer" Acquisitions of Appreciated Property from a C Corporation by a REIT if the REIT's Basis Immediately After Acquisition Is Equal to Amount Paid*

Finally, we would like to raise a purely nomenclature issue concerning the use of the word "transfer." Both Treas. Reg. § 1.337(d)-7(a)(ii) and Prop. Treas. Reg. § 1.337-7(a)(ii) define a "conversion transaction" as including the "transfer" of property owned by a C corporation to a REIT. Section 1.337-7(d)(1) of the 2012 Proposed Regulations excludes from the application of the deemed sale rule any conversion transaction in which the C corporation recognizes gain or loss. Section 1.337-7(d)(3) of the 2012 Proposed Regulations excludes from the application of the 2003 Deemed Sale Rule any "transfer" by a C corporation of property with a built-in gain to a REIT if the C corporation's gain is not recognized by reason of either section 1031 or section 1033. The Examples in the 2012 Proposed Regulations address situations in which the C corporation with appreciated property transfers that property to the REIT either solely for replacement property, or for replacement property and cash pursuant to a transaction that qualifies for nonrecognition under either section 1031(a) or section 1031(b). The examples do not address when a REIT simply purchases appreciated property from a C corporation for cash or other consideration (presumably a "transfer" under the 2012 Proposed Regulations), but the REIT is not involved further in what the C corporation may or may not do with the transferred cash. For example, the C corporation from which the REIT purchases property may be using the cash from the REIT as part of its own deferred section 1031 transaction, which does not involve the REIT.

Because the REIT is no longer involved in the transaction after it purchases the property from the C corporation, it would have no way of knowing the extent to which, if at all, the C corporation might or might not recognize gain, whether pursuant to the application of section 1031, 1033 or any other section of the Code. Furthermore, because the REIT's basis in the acquired property is equal to the amount paid, the REIT should have no built-in gain with respect to the acquired property (other than the rare situation of a transaction covered by the gift sales rule).

Accordingly, we request that the final regulations exclude from the definition of "transfer" (either through a clarification in the preamble or a specific provision in the final regulations) the situation in which a REIT's basis in appreciated property acquired from a C corporation immediately after acquisition is equal to the amount paid by the REIT for the property from the C corporation in an arm's length transaction. If so, a subsequent disposition of the property by the REIT within 10 years after acquisition would not be subject to the 2003 Deemed Sale Rule. (As noted above, because the REIT would have a cost basis in the property transferred by the C corporation determined by the amount paid by the REIT, it should not have any built-in gain on a subsequent sale of the property within the 10-year period after acquisition.)

Thank you again for the opportunity to submit these comments. Feel free to contact me at tedwards@nareit.com or Dara Bernstein, NAREIT's Senior Tax Counsel, at dbernstein@nareit.com if you would like to discuss these issues in greater detail.

Respectfully submitted,

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