NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

November 10, 2010

VIA INTERNET [http://www.regulations.gov (REG–144762-09)]

CC:PA:LPD: PR (REG-144762-09)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW.
Washington, D.C. 20004

Re: Guidance Regarding Deferred Discharge of Indebtedness Income for Partnerships

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity to provide comments with respect to proposed (and temporary) regulations (*REG–144762-09*) (COD regulations) under section 108(i)[1] of the Internal Revenue Code of 1986, as amended (Code), which primarily affect partnerships and S corporations regarding, among other things, the acceleration of deferred discharge of indebtedness (COD) income (deferred COD income) under section 108(i)(5)(D). Section 108(i) was enacted as part of the American Recovery and Reinvestment Act of 2009 (ARRA).

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.

[1] Unless otherwise provided all "section" references herein shall be to a section of the Code.

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I. EXECUTIVE SUMMARY

NAREIT appreciates the issuance of this guidance. With that said, NAREIT recommends the following changes.

First, NAREIT recommends that the IRS reiterate in final regulations its conclusion in Rev. Proc. 2009-37 that REITs are not pass-through entities for purposes of section 108(i).

Second, solely for purposes of section 108(i), NAREIT recommends that an electing partnership be considered engaged in a trade or business provided that at least 30 percent of its rental real property's original tax basis is depreciable, consistent with Treas. Reg. § 1.469-2T(f)(3).

Third, for purposes of determining whether a debt instrument was issued in connection with the conduct of a trade or business by a partnership based in part on whether gross fair market value of the trade or business assets of the issuing partnership's represented at least 80 percent of the gross fair market value of that partnership's total assets on the date of issuance, we recommend that the regulations permit the partnership to include the proportionate assets of a lower tier pass-through entity in which it owns a substantial interest (such as 20 percent or more).

Fourth, for purposes of determining whether an electing entity has disposed of "substantially all" of its assets, a facts and circumstances test should govern, and the test of 90 percent of its net assets and 70 percent of its gross assets as proposed in the COD Regulations should be at most a rebuttable presumption.

Finally, the legislative history concerning whether and when filing a bankruptcy petition will cause acceleration of deferred COD income is ambiguous. Accordingly, NAREIT recommends that the Treasury Department and IRS clarify that an electing taxpayer in bankruptcy proceedings will not accelerate deferred COD upon emerging from such proceedings.

II. DISCUSSION

A. REITs Are Not Pass-Through Entities

For purposes of clarity, NAREIT recommends that the final regulations reiterate the conclusion in Rev. Proc. 2009-37 that REITs are not pass-through entities for purposes of section 108(i).

B. Trade or Business Safe Harbor

Section 108(i) only permits deferral of COD income with respect to the reacquisition of an "applicable debt instrument." Section 108(i)(3) defines "applicable debt instrument" issued by a partnership as one which was issued "in connection with the conduct of a trade or business by such [partnership]." Notably, section 108(i)(3) does not require the conduct of an **active** trade or business. Unfortunately, section 108(i) statutory language does not provide any guidance as to what is the conduct of a trade or business, and the absence of such guidance tends to impede the

Congressional goal of providing temporary relief to a distressed borrower that reacquires a debt instrument originally issued in connection with the conduct of a trade or business. An objective standard would be helpful in providing guidance to such borrowers.

Accordingly, NAREIT proposes a safe harbor under which debt issued by a partnership to acquire or improve real property held for rental purposes be treated as incurred by the partnership in connection with a trade or business of the partnership for purposes of section 108(i)(3)(A)(ii) if 30 percent or more of the total tax basis (without reduction for depreciation deductions) of the partnership's property is allocable to depreciable property. *See* Temp. Reg. §1.469-2T(f)(3) (treating a taxpayer's net passive income from rental activity as non-passive if less than 30 percent of the unadjusted basis of the property used or held for use by customers in such activity during the taxable year is subject to the allowance for depreciation under section 167).

Conversely, outside the safe harbor, *i.e.*, if less than 30 percent of the total tax basis (without reduction for depreciation deductions) of the property is allocable to depreciable property, the determination of whether the debt was issued by the partnership in connection with its trade or business would be based on current law, which is somewhat uncertain and presumably would turn on the facts and circumstances.

C. Lower-Tier Pass-Through Entities

Treas. Reg. § 1.108(i)-2T(d)(1) provides five safe harbors under which a debt instrument issued by a partnership or an S corporation is deemed to be issued in connection with a partnership's trade or business for purposes of section 108(i). One of those safe harbors, listed under Treas. Reg. § 1.108(i)-2T(d)(1)(i), requires that "the gross fair market value of the trade or business assets of the partnership … that issued the debt instrument represented at least 80 percent of the gross fair market value of that partnership's … total assets on the date of issuance."

Most income-producing real estate is held through partnerships, which often have multiple tiers. Because partnerships are pass-through entities for tax purposes, we request that the final regulations allow upper-tier partnerships to consider their proportionate assets held through lower-tier partnerships or limited liability companies in which they hold a significant percentage (*e.g.*, at least 20 percent) as part of their trade or business assets. *Cf*. Treas. Reg. § 1.856-3(g) (treating a REIT as owning the proportionate assets of a partnership in which it is a partner, based on its capital interest).

D. "Substantially All" 90 percent/70 percent Test

1. *"Substantially All" – Section 108(i) and the COD Regulations*

If an electing partnership defers COD income under section 108(i), and it experiences an "acceleration" event as defined by section 108(i)(5)(d), its deferred COD income is triggered and recognized immediately in the year of the acceleration event. Section 108(i)(5)(d)(i) states that one such acceleration event is "the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case).” Neither the Code nor related legislative history explicitly defines the term “substantially all” for this purpose. Newly issued Treas. Reg. § 1.108(i)-2T(b)(6)(B) does provide more detailed guidance on the meaning of “substantially all” in the context of COD deferral under section 108(i). The temporary regulation states that “substantially all of a partnership’s assets means at least 90 percent of the fair market value of the net assets, and at least 70 percent of the fair market value of the gross assets, held by the partnership immediately prior to the sale, exchange, transfer, or gift.”

2. *“Substantially All” – Section 368 & Rev. Proc. 77-37*

The definition of substantially all for section 108(i) appears to have been borrowed from IRS guidance related to certain corporate reorganization transactions. Sections 354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), 368(a)(2)(D), and 368(a)(2)(E)(i) all contain the term “substantially all”. Neither the Code nor the corresponding regulations provide an explicit test for calculating when “substantially all” of a corporation’s assets have been transferred.” For advance ruling purposes only, the IRS provides in Rev. Proc. 77-37, 1977-2 C.B. 568, that the substantially all requirement will be met if “there is a transfer (and in the case of a surviving corporation under section 368(a)(2)(E)(i), the retention) of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the corporation immediately prior to the transfer.” Rev. Proc. 77-37 specifically states that “these operating rules do not define, as a matter of law,” substantially all under the Code. Ultimately, the test is a “facts and circumstances” test. *See* Rev. Rul. 88-48, 1988-1 C.B. 117.

3. *“Substantially All” – Section 368(a)(1)(G)*

Under section 368(a)(1)(G), a G reorganization encompasses “ the transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.” Section 368(a)(1)(G) also includes a substantially all requirement. With that said, Rev. Proc. 77-37 specifically does not apply to G reorganizations. Further, the case law analyzing substantially all in the context of G reorganizations is highly distinguishable from other corporate reorganizations. This result is in large part because G reorganizations are likely to involve insolvent or unhealthy debtors. The legislative history to Section 368(a)(1)(G) specifically addresses this issue and provide for a relaxed standard of substantially all in the case of G reorganizations. The relevant Senate report provides that:

> The "substantially all" test in the "G" reorganization provision is to be interpreted in light of the underlying intent in adding the new "G" category, namely, to facilitate the reorganization of companies in bankruptcy or similar cases for rehabilitative purposes. Accordingly, it is intended that facts and circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditors or to sell assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a "G" reorganization. For example, a transaction is not precluded from satisfying the

> "substantially all" test for purposes of the new "G" category merely because, prior to a transfer to the acquiring corporation, payments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business .

See S. Rep. No. 1035, 96th Cong., 2d Sess. 35-36 (1980). *See also* PLRs 201032009 and 2010 25018 ("substantially all" test met when 50 percent of gross assets and 70 percent of operating assets were transferred as part of a G reorganization).

4. *Recommendation: Consider 90 percent/70 percent Test a Rebuttable Presumption, and Allow For a "Facts and Circumstances" Analysis in Determining Transfer of "Substantially All"*

An electing partnership deferring COD income under section 108(i) is likely to be in some financial distress. For example, its liabilities may exceed its assets, in which case, it would have negative net assets. At the same time, it may be financially prudent for the electing entity to attempt to repay some or all of its creditors, which would reduce its gross assets, but put it in a better financial position in the long term. As in the case of G reorganizations, the use of the 90 percent net-70 percent gross test for a financially distressed entity may not be appropriate.

Just as a different standard is appropriate in the G reorganization context in order to permit a troubled corporation to reorganize as a viable business, here too a different standard is appropriate to allow an electing partnership to repay creditors and maintain its long term viability, provided that the IRS' interest in preserving the entity's ability to pay its deferred tax liability is not compromised. As a consequence, NAREIT recommends that the 90 percent net-70 percent gross test for determining whether "substantially all" of an electing entity's assets have been transferred be considered at most a rebuttable presumption and that instead the IRS permit a "facts and circumstances" test to be employed.

E. Bankruptcy Filing and Acceleration of Deferred COD Income

NAREIT recommends that the Treasury Department and IRS clarify in final regulations that emerging from a bankruptcy filing under Title 11 does not cause acceleration of deferred COD, consistent with the legislative history to the ARRA. The Conference Report to this legislation states the following with respect to deferred COD:

> In a case under title 11 or a similar case, any deferred items are taken into income as of the day before the petition is filed. Deferred items are accelerated in a case under title 11 where the taxpayer liquidates, sells substantially all of its assets, or ceases to do business, but not where a taxpayer reorganizes and emerges from the title 11 case.

H.R. Rep. No. 16, 111th Cong. 1st Sess. 565 (2009).

On the one hand, the Conference Report appears to indicate that filing a title 11 petition causes acceleration of deferred items, while on the other hand, it indicates that reorganization and emergence from a title 11 proceeding would not cause acceleration. It appears that these inconsistencies can be reconciled by clarifying that the former case involves the situation when a taxpayer with realized and deferred COD income enters bankruptcy proceedings, and the latter involves the situation in which a taxpayer first enters bankruptcy proceedings, after which it realizes and defers COD income. Accordingly, we recommend amending the final regulations to clarify them accordingly so that a taxpayer in the latter situation is not forced to consider its newly realized COD income as having been incurred the day before it filed its bankruptcy petition.

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Feel free to contact me or Dara Bernstein, NAREIT's Senior Tax Counsel, if you would like to discuss these issues in greater detail.

Respectfully submitted,

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