NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

January 17, 2014

VIA E-MAIL: Tax_Reform@Finance.Senate.gov

The Honorable Max Baucus
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments on International Business Tax Reform Staff Discussion Draft

Dear Chairman Baucus:

The National Association of Real Estate Investment Trusts[1] (NAREIT) welcomes the opportunity to provide comments on the international business tax reform staff discussion draft released on November 19, 2013 (the Discussion Draft).[2] NAREIT looks forward to working with the Finance Committee (the Committee) with respect to the proposals contained in the Discussion Draft.

NAREIT supports the Discussion Draft's goals of modifying the U.S. tax system to promote U.S growth and job creation. Because REITs generally invest overseas for the purpose of generating additional current income to distribute to shareholders on a timely basis (as they are statutorily mandated to do), NAREIT believes that U.S. REIT-earned foreign income is not voluntarily "locked-out" of the U.S and, with respect to REITs, the Discussion Draft's goal of "end[ing] the lock-out effect by taxing the foreign income of U.S. businesses either immediately when earned or not at all" would result inappropriately in "phantom income" for REIT shareholders and/or misplaced entity-level taxation.

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[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'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] Available at http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14. References to "section" or "§" in this letter refer to sections of the Internal Revenue Code of 1986, as amended (the Code or I.R.C.). References to "Proposed section" refer to the Code as it would be amended by the Discussion Draft. Unless otherwise provided, the use of the term "Discussion Draft" incorporates three international tax reform discussion draft documents: the International Tax Discussion Draft Common; the International Tax Discussion Draft Option Y; and the International Tax Discussion Draft Option Z.

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EXECUTIVE SUMMARY

As relevant to this letter, the Discussion Draft proposes the following: 1) modifying the current FIRPTA rules, by, among other things: a) conforming the definition of "portfolio investor" for FIRPTA purposes from 5% to the 10% used in tax treaties and which is applicable to foreign investment in U.S. debt securities; b) generally reversing one part of Notice 2007-55 with respect to the treatment of liquidating distributions of a domestically controlled qualified investment entity (DCQIE) pursuant to which such distributions are currently taxed as a sale of real estate subject to FIRPTA, rather than being taxed as a sale of stock; and, c) exempting from the rules of section 897 any U.S. real property interest held by a qualified foreign pension fund or by a foreign entity wholly-owned by a qualified foreign pension fund; 2) repealing the "portfolio interest exemption" in respect of interest on corporate debt to a particular country's residents unless U.S. residents are eligible for similar exemptions under U.S. income tax treaties with those countries; 3) enacting a transition rule (Transition Rule) that essentially would impose a 20% U.S. tax on the accumulated deferred earnings of controlled foreign corporations (CFCs); 4) essentially imposing a minimum U.S. entity-level tax of either: a) 80% of the U.S. corporate tax rate (under the Discussion Draft's Option Y) on low-taxed foreign income; or, b) 60% of the U.S. corporate tax rate on CFCs active foreign income (and 100% of non-active CFC income) (Discussion Draft's Option Z) (in both cases, the Minimum Taxation Rule); and, 5) repealing the "check-the-box" rules for all subsidiary disregarded entities of CFCs.

NAREIT fully supports and endorses the intent of the Discussion Draft to modify the current FIRPTA rules in order to reduce the barriers embedded in the current Code imposed on non-U.S. investors who inject equity into U.S. real estate. With that said, NAREIT believes that the Discussion Draft's proposals to apply revised attribution rules in the case of FIRPTA are inappropriately broad. Specifically, they could cause a current DCQIE to be viewed as not domestically controlled merely because its U.S. owner(s) own(s) a foreign corporation. NAREIT suggests modifications below. NAREIT also recommends a simplification to assist stock exchange-listed REITs determine whether they are DCQIEs. NAREIT recommends that the comprehensive provisions of the Real Estate Investment and Jobs Act of 2013, S. 1181, whose provisions include many of these reforms, as well as the broader provisions of President Obama's Fiscal Year 2014 Budget relating to foreign pension funds, be included in any reform legislation.

NAREIT believes that certain aspects of the Discussion Draft's deemed repatriation and expanded current inclusion of undistributed foreign income proposals would cause unintended and adverse consequences to REITs. Among other issues, deeming a REIT to have phantom income would cause the REIT to have to distribute such income without the corresponding cash, or lose its REIT status. As a result, NAREIT believes that REITs should not be subject to a minimum U.S. corporate level tax on un-repatriated foreign earnings.

Similarly, as the real estate industry continues its fragile recovery, the Discussion Draft's effective repeal of the portfolio interest withholding exception would limit the industry's ability to obtain capital through debt offerings to residents in countries that may not allow for reduced withholding under treaties.

Finally, NAREIT believes that the Discussion Draft's proposal to treat disregarded entities of CFCs as corporations could have unintended and adverse consequences for REITs without furthering any stated policy goal. This proposal in effect would eliminate a common structure for REITs investing overseas that allows them to generate active rent for Subpart F rules while satisfying local employment laws. Under these local laws and practices, often the individuals who provide property management services are employed by a separate property manager affiliate in the group rather than the real estate holding entity. Along those lines, NAREIT also recommends a modification to the Subpart F rules so that the services provided by an affiliate could be allowed to be taken into account for Subpart F testing as to whether the rents are active, particularly considering that many businesses outside the U.S. now house such employees abroad in an affiliated management company.

DISCUSSION

A. Background

1. REITs Generally

Authorized by Congress over 50 years ago and based on the model for mutual funds, REITs are the most practical way through which investors can invest in professionally managed portfolios of real estate assets. Stock in publicly traded REITs is typically held by retail investors, either directly or indirectly through mutual funds. Investing in a diverse, professionally managed portfolio of real estate assets gives all Americans access to, and the benefits of investing in, large scale income-producing real estate without the risks and transaction costs associated with investing in individual properties.

Like a mutual fund, a REIT is not subject to entity-level federal income tax on taxable income that it distributes to its shareholders as dividends each year. These dividends are taxed at the highest rate applicable to ordinary income.[3] However, to achieve this tax treatment, REIT must satisfy several tests related to the nature of the REIT's assets, the sources of its income, its mandatory distributions to its shareholders, and the ownership of its stock.[4] These income and asset tests, coupled with the mandatory distribution rules, and the fact that REITs may not pass through losses and credits to investors, distinguish REITs from partnerships and other fiscally transparent entities.

[3] To the extent a REIT has net capital gain in a year, it may designate its dividends for that year as being capital gain dividends subject to capital gain rates.

[4] For further detail regarding the positive effects of REITs on the economy and investors, please see NAREIT's submission to the House Ways and Means Committee's Real Estate, Energy, International, Pensions/Retirement, Debt, Equity and Capital, Education and Family Benefits, Charitable/Exempt Organizations, Financial Services and Small Business Tax Reform Working Groups dated April 15, 2013, available at http://waysandmeans.house.gov/uploadedfiles/nareit_wg_comments.pdf .

2. REIT Gross Income and Asset Tests and the 90% Distribution Requirement

a. Gross Income Tests

To ensure that a REIT derives substantially all of its income from real estate related sources, a REIT is required to derive at least 75% of its gross income each year from, *inter alia*: 1) rents from real property; 2) dividends from stock in other REITs; 3) interest on obligations secured by mortgages on real property or on interests in real property; and, 4) gain from the sale or other disposition of real property, including interests in other REITs, real property and interest in mortgages on real property that is not "dealer property" (*i.e*., property held primarily for sale to customers in the ordinary course of business)[5] (75% Gross Income Test). A REIT is also required to derive at least 95% of its gross income each year from any income that is qualifying for the 75% Gross Income Test plus certain types of passive income including any type of interest, dividends, and gains from the sale or other disposition of stock, securities and real estate that is not "dealer property"[6] (95% Gross Income Test, and together, the Gross Income Tests).

b. Asset Tests

Among other requirements: 1) at least 75% of the value of a REIT's total assets quarterly must be from "real estate" sources (including stock in other REITs[7] and real estate both in and outside the U.S.) (75% Asset Test); 2) a REIT cannot own more than 10% of the vote or value in a corporation other than another REIT, a "taxable REIT subsidiary" (TRS) or a wholly-REIT owned "qualified REIT subsidiary" (QRS)[8] (10% Asset Test); and, 3) the value of securities of all TRSs cannot amount to more than 25% of a REIT's assets (TRS Asset Test, together with the 75% Asset and the 10% Asset Test, the REIT Asset Tests).[9] A TRS is a fully taxable corporate subsidiary of a REIT. A REIT and TRS must elect jointly for the TRS to be treated as a TRS. To ensure that a TRS is subject to an appropriate level of corporate taxation, the amount of debt and rental payments from a TRS to its affiliated REIT is limited. Further, a 100% excise tax is imposed to the extent any transaction between a TRS and its affiliated REIT (or that REIT's tenants) is not conducted on an arms' length basis.[10]

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[5] I.R.C. § 856(c)(3).

[6] I.R.C. § 856(c)(2).

[7] The income and asset tests make clear that REITs may earn qualifying income and hold qualifying assets in other REITs. These rules are helpful, particularly in the context of mergers and acquisitions. For example, a publicly traded REIT may spin off a subsidiary REIT with a slightly different investment focus (*e.g.,* General Growth Properties, Inc.'s spin off of Rouse Properties, Inc. in 2012). Similarly, an acquiring REIT may retain an acquired REIT as a subsidiary entity, in order to preserve goodwill, limit difficulties in obtaining lender consents, minimize transfer taxes, limit tort liability, etc.

[8] Under section 856(i), a QRS is treated as a disregarded entity of its parent REIT.

[9] I.R.C. § 856(c)(4).

[10] I.R.C. § 857(b)(7).

c. Distribution Test

A REIT must also distribute 90% of its "REIT taxable income" (excluding net capital gain) each year (the 90% Distribution Requirement).[11] Like a mutual fund, a REIT is allowed a dividends paid deduction in computing its taxable income.[12] Thus, to the extent a REIT distributes 100% of its taxable income, it will not pay corporate tax and most REITs usually distribute 100% of their taxable income. As with mutual funds, the tax burden from a REIT's business is borne by the REIT's shareholders. Securities and Exchange Commission (SEC)-registered REITs paid out approximately $29 billion in dividends in 2012, most of which were taxed at the ordinary income rate, not the lower rate applicable to qualified corporate dividends. Approximately 200 REITs that are listed on U.S. stock exchanges currently have an equity market capitalization of over $700 billion.

A limited exception from the 90% Distribution Requirement is available for certain types of "phantom" or "noncash" income recognized by a REIT. [13] A REIT is not required to distribute "excess noncash income," which is certain noncash income in excess of 5% of the REIT's taxable income (excluding net capital gains).[14] The potential sources of "excess noncash income" under section 857(e) include, *inter alia,* original issue discount (OID) and cancellation of indebtedness (COD) income.[15] A REIT, however, is required to pay corporate income tax on any "excess noncash income" that it does not distribute to its shareholders.

Notwithstanding the limited exception for excess noncash income, REITs are generally required to distribute phantom income and generally do so. In order to raise the cash necessary to distribute phantom income as required by the 90% Distribution Requirement, a REIT may incur debt or sell assets it otherwise would hold on a long-term basis. Neither of those alternatives is typically in the best economic interests of the REIT's shareholders. Incurring debt to satisfy the 90% Distribution Requirement will necessarily increase the REIT's leverage beyond what it otherwise would have been, and that increased leverage may make it more difficult for the REIT to survive an economic downturn.

Ultimately, if the REIT's phantom income causes a failure of the 90% Distribution Requirement, the REIT will lose its REIT qualification, which would cause the REIT to be subject to corporate income tax for the year of the failure and for the following four years**,** unless the REIT obtains

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[11] I.R.C. § 857(a)(1)(A).

[12] I.R.C. § 857(b)(2)(B).

[13] I.R.C. § 857(a)(1)(B).

[14] I.R.C. § 857(e)(1).

[15] I.R.C. § 857(e)(2). Excess noncash income also includes: 1) "excess inclusion income," a type of phantom income recognized by a holder of a residual interest in a real estate mortgage investment conduit (REMIC) or a taxable mortgage pool; 2) gain from certain failed section 1031 "like-kind" exchanges; and, 3) rental income accelerated under section 467 (requiring accrual of rental income on level basis on certain leases with back-loaded rent). I.R.C. § 857(e)(2)(A), (B), and (C). In the case of OID, excess inclusion income, and section 467 income, the "excess noncash income" is the amount in excess of the cash actually received on the related investment.

the consent of the IRS to maintain its REIT status.[16] The corporate income tax from a failure to satisfy the 90% Distribution Requirement would greatly reduce the distributions the REIT could pay its shareholders (especially since the company likely would have already distributed most of its cash because of the distribution requirement) and likely would significantly reduce the value of the REIT's stock. In sum, phantom income can cause significant negative consequences for a REIT and its shareholders.

B. Current Law: FIRPTA-U.S. Taxation of Certain Foreign Investments in U.S. Real Estate Corporations

Current law treats gains of foreign investors from the disposition of U.S. real property interests as generally subject to U.S. tax (as "effectively connected income") under FIRPTA, except in the following cases: 1) portfolio investments of not more than 5% of a stock exchange-listed U.S. real estate corporation's stock, including that of a stock exchange-listed REIT; and, 2) sales of stock in a qualified investment entity more than half of whose stock is owned by U.S. persons (a DCQIE). Additionally, IRS Notice 2007-55 treats REIT liquidating distributions and redemptions as property distributions rather than as sales of stock, thus making them subject to FIRPTA (contrary to longstanding practice prior to issuance of the Notice). On the other hand, gains recognized by U.S. pension funds from the disposition of U.S. real property interests (including interests in real estate corporations such as REITs) are generally exempt from U.S. tax.

C. REIT Investments Overseas

1. Generally

In Rev. Rul. 74-191, 1974-1 C.B. 170, the IRS concluded that otherwise-qualifying assets do not fail to satisfy the REIT Asset Tests in section 856(c)(4) merely because the assets are located outside the United States. Some REITs invest overseas as a way of maximizing their investment opportunities as well as relationships with their tenants and/or foreign partners.

It appears that the principal focus of the Discussion Draft is to remove U.S. tax incentives to invest and retain earnings abroad. Notably, REITs generally are not incented to, and do not invest abroad, for tax savings. The reasons include the following:

- REITs generally distribute all of their taxable income (90% of which legally they must distribute) and are not taxed on the income they distribute; accordingly, they do not seek to defer U.S. tax liabilities.

- REITs generally cannot effectively use foreign tax credits and, accordingly, do not view low-taxed foreign income as preferable to the same amount of U.S. income.

[16] I.R.C. § 856(g)(3) (prohibiting an entity that has failed to qualify as a REIT from electing REIT status for the next four taxable years).

- REITs are attractive to investors as dividend paying stocks and strive to increase dividends rather than retain earnings.

- REITs generally use flow-through structures for foreign investments to the extent such investments can be structured to generate qualifying gross income for purposes of the applicable Gross Income Tests and use corporations to earn nonqualifying income or hold nonqualifying assets and/or to hold cash that is prohibited from being distributed due to local laws.[17] As further described above, REITs are limited in their ownership of such corporations by the REIT Asset Tests.

- REITs typically do not have valuable intangibles that can be held in low-tax countries. Use of entities formed in "low-tax" jurisdictions, as part of overseas REIT structures is designed to maximize the repatriation of foreign earnings.

Accordingly, the focus of NAREIT's comments below is on provisions included in the Discussion Draft that appear to address deferral structures, but that might inadvertently and adversely affect REIT qualification, primarily the REIT distribution requirements and Gross Income Tests.

2. Investing Through Fiscally Transparent Entities

Specifically, REITs may invest in foreign real estate through a U.S. partnership, limited liability company or disregarded entity or a foreign limited liability entity that "checks the box" to be a disregarded entity or partnership; these entities may be regarded or corporate entities for foreign tax purposes. By doing so, the REIT achieves immediate and ongoing flow-through of foreign income that maximizes distributions to shareholders and complies with the REIT income and asset tests similar to its investment in U.S. real estate.[18]

In many cases, once a top-tier entity is established, regional investments (*e.g.*, in the European Union or throughout Asia) are made through subsidiary disregarded entities in order to achieve the most efficient structure for operational, liability and tax purposes. Doing so allows for a greater amount of income to flow through to REIT shareholders. As REITs generally do not claim foreign tax credits and cannot pass such credits through to shareholders, maximizing efficiencies allows REITs to be able to distribute more income currently to shareholders. Thus, the REIT's investments are structured to maximize current income and distributions to shareholders, not to defer U.S. taxes.

With that said, a REIT may face a number of issues by investing overseas through flow-through entities. First, if the overseas entity or the REIT's foreign partner in the overseas entity inadvertently invests in non-qualifying REIT assets or generates non-qualifying REIT income,

[17] Some countries prohibit cash distributions from companies with "negative earnings" as defined under local law, which may exist as a result of non-cash deductions such as depreciation.

[18] Under Treas. Reg. § 1.856-3(g), a REIT is deemed to own its proportionate interest of the assets and income of a partnership in which it owns an interest.

the REIT's tax status could be jeopardized. Second, many countries limit the actual cash distributions that can be made to overseas shareholders. Often this limit will be based on book income; thus, companies may be prohibited from distributing all available cash if they claim deductions for depreciation (that is, a non-cash expense). As a result, they have lower book income than otherwise available cash. If so, although Treas. Reg. § 1.856-3(g) requires the REIT to include its proportionate share of the flow-through entity's income in its taxable income, and the 90% Distribution Test requires the REIT to distribute 90% of such income, the REIT may not have access to the flow-through entity's cash. As a result, the REIT may consider making certain of its overseas investments through corporate entities to avoid this issue.

3. Investment through Corporate Entities

Because a REIT only may own up to 10% of a corporation other than a REIT, QRS or TRS, if a REIT invests in a foreign corporate entity, typically the REIT and the foreign corporate entity will elect for the foreign entity to be a TRS. By investing through a TRS, rather than a flow-through entity, the REIT avoids the risk that a foreign flow-through entity inadvertently may invest in non-qualifying REIT assets or generate non-qualifying REIT income that could jeopardize the REIT's tax status. Additionally, the REIT avoids the negative consequences associated with the foreign entity's being legally prevented from distributing all of its available cash to the REIT.

Even if a REIT does invest overseas through foreign TRSs, the REIT is limited in the value of securities it can own in TRSs. As noted above, the value of the securities in all of its TRSs cannot exceed 25% of the REIT's total gross assets. Thus, to the extent the REIT may approach that limit, it would be required to make further investments through flow through entities.

As noted above, REITs typically do not invest overseas for purposes of deferral. First, in certain cases, rental income earned by the TRSs may be considered Subpart F income (if the company earning the rental income is not the same company whose employees are managing the property).[19] Thus, if the REIT is a "United States shareholder" with respect to CFCs, the REIT is required by section 951(a)(1)(A)(i) to include in its gross income its pro rata share of the Subpart F income, as defined in section 952(a), of any such CFCs. Additionally, as a result of being a

[19] Foreign personal holding company income (FPHCI), one type of Subpart F income, is defined to include "…rents, … other than…rents and royalties derived in the active conduct of a trade or business and which are received from a person that is not a related person." Section 954(c)(2)(A); Treas. Reg. § 1.954-2(b)(6).

Further, Treas. Reg. § 1.954-2(c) provides "[e]xcluded rents-(1) Active conduct of a trade or business. Rents will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such rents are derived by the [CFC] (the lessor) from leasing . . . (ii) Real property with respect to which the lessor, through its own officers or staff or employees, regularly performs active and substantial management and operational functions while the property is leased . . . ."

Notably, the IRS has held in Rev. Rul. 2001-29, 2001-1 C.B. 1348 that, in the context of the section 355 active trade or business requirement: "A REIT can be engaged in the active conduct of a trade or business within the meaning of § 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property."

United States shareholder with respect to CFCs, the REIT is required by section 951(a)(1)(B) to include in its gross income its share of the amount determined under section 956 with respect to each CFC for the relevant tax year (but only to the extent not excluded from gross income under section 959(a)(2)).

If the REIT is not a United States Shareholder of a CFC, the CFC may be considered a passive foreign investment company (PFIC). If so, the REIT's tax treatment will vary based on whether it has made a qualified electing fund (QEF) election for that PFIC. As a result of being a shareholder in PFICs for which the REIT has made QEF elections, the REIT is required under section 1293(a) to include annually in its gross income its pro rata share of that year's ordinary earnings and net capital gain income of each such QEF. As a result of being a shareholder in PFICs for which the REIT has not made any elections (frequently as a result of not having identified the entities as PFICs), the REIT is required to include amounts in income (as ordinary income) pursuant to section 1291 and is potentially subject to an entity level tax computed at the time distributions are made by the PFIC.

In either case, the Subpart F income or the PFIC Inclusion likely will not be treated as qualifying as 75% Gross Income. The IRS has issued a number of private letter rulings holding that Subpart F income inclusions and/or PFIC inclusions in certain cases qualified as 95% Gross Income.[20] However, these rulings are taxpayer-specific and cannot be relied upon as precedent.

D. Discussion Draft Comments/Recommendations

1. NAREIT Supports the Goals of the Discussion Draft's FIRPTA Proposals and Suggests Modest Changes

a. Discussion Draft's Main FIRPTA Proposals Would Help Real Estate's Fragile Economic Recovery

NAREIT **supports** the Discussion Draft's proposals to modify the current FIRPTA rules, by, among other things:

1) conforming the definition of "portfolio investor" for FIRPTA purposes from 5% to the 10% used in tax treaties and/or which is applicable to foreign investment in U.S. debt securities;[21]

2) generally reversing one part of Notice 2007-55 with respect to the treatment of liquidating distributions of a DCQIE pursuant to which such distributions are currently

[20] *See, e.g.*, PLRs 201226004 (available at: http://www.irs.gov/pub/irs-wd/1226004.pdf) and 201246013 (available at: http://www.irs.gov/pub/irs-wd/1246013.pdf).

[21] It is important to note that FIRPTA exemptions for foreign shareholders owning up to 10% of a publicly traded REIT were included in H.R. 5901, the "Real Estate Jobs and Investment Act of 2010," which was passed by the House of Representatives by a vote of 402-11 on July 30, 2010.

taxed as a sale of real estate subject to FIRPTA, rather than being taxed as a sale of stock;[22] and,

3) exempting from FIRPTA any U.S. real property interest held by a qualified foreign pension fund or by a foreign entity wholly-owned by a qualified foreign pension fund. NAREIT supports this proposal, but believes the proposal should be clarified to include pension plans of foreign governments.

These important improvements to FIRPTA would help encourage additional equity investment in U.S. real estate, and would help supply the equity needed to pay off or refinance the hundreds of billions of real estate debt maturing in the next few years.

The first proposal would conform FIRPTA to other Code definitions of "portfolio" investors, such as the portfolio interest exemption under which foreigners pay no U.S. tax on interest payments made to them connected to U.S. debt so long as they own less than 10% of the debt issuer's stock or partnership interest. It would also conform to the test for portfolio investors under Article 10(2)(a) the U.S. Model Income Tax Convention under which the 15% withholding rate (compared to the Code's 30% withholding rate) on dividends is available to individuals who own 10% or less of the voting stock in a corporation.[23]

In terms of the second proposal, prior to 2007 most practitioners believed that the liquidation of a DCQIE with U.S. and foreign shareholders should be treated like the liquidation of a DCQIE with only U.S. shareholders, *i.e.*, as a sale of stock. The IRS essentially confirmed this result in a private letter ruling later withdrawn in 2004. However, the IRS later issued Notice 2007-55 in which it stated its intention to issue regulations that would reverse this result and treat a liquidation of a DCQIE as the sale of property with respect to the foreign shareholders (while continuing to treat the liquidation as a sale of stock with respect to the U.S. shareholders). This notice greatly upset settled expectations and negatively affected foreign investment in U.S. REITs. The second proposal would reverse this part of Notice 2007-55, thereby confirming the IRS' original position regarding the liquidation of a domestically-controlled REIT.

The Discussion Draft's third proposal, specifically, section 93(c) of the Discussion Draft Common, would define a qualified foreign pension fund (for purposes of the FIRPTA exemption) as any non-U.S. trust, corporation or other organization or arrangement: 1) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more

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[22] The first two proposals are largely consistent with the Real Estate Investment and Jobs Act of 2013, S. 1181, which was introduced on June 18, 2013, by Senators Bob Menendez (D-NJ) and Mike Enzi (R-WY), and now has 33 bipartisan co-sponsors. The Discussion Draft's proposed modifications to Notice 2007-55 appears to be consistent with recommendations contained in a comment letter dated June 10, 2008 by the American Bar Association Section on Taxation (available at http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2008/080610realestate200755.authcheckdam.pdf) .

[23]http://www.irs.gov/pub/irs-trty/model006.pdf.

employers in consideration for services rendered; 2) which does not have a single participant or beneficiary with a right to more than five percent of its assets; 3) which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates; and, 4) with respect to which, under the laws of the country in which it is established or operates: i) contributions to such organization or arrangement that would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such organization or arrangement; or, ii) taxation of any investment income of such organization or arrangement is deferred or such income is taxed at a reduced rate.

The Discussion Draft's third proposal appears to be narrower than a similar proposal in President Obama's Fiscal Year 2014 Budget.[24] The Administration's proposal would exempt from the application of FIRPTA gains of foreign pension funds from the disposition of U.S. real property interests. Under the Administration's proposal, a foreign pension fund would generally mean a trust, corporation or other organization or arrangement that is created or organized outside of the United States; generally exempt from income tax in the jurisdiction in which it is created or organized; and substantially all of the activity of which is to administer or provide pension or retirement benefits. The reasoning behind the Administration's proposal is to treat foreign pension funds that invest in U.S. real property comparably with U.S. pension funds that are exempt from tax.

The Discussion Draft proposal is also less comprehensive than the reform proposals contained in S. 1181 (the "Real Estate Investment and Jobs Act of 2013"). That bill extends the 10% FIRPTA exemption to widely-held, publicly-traded "qualified collective investment vehicles" that are accorded modified pass-through treatment under a comprehensive income tax treaty with the United States

Overall, NAREIT believes that this Discussion Draft proposal would encourage additional investment in U.S. real estate, which U.S. firms can then deploy to stabilize values, launch new projects and create jobs in the United States.

NAREIT recognizes that the Discussion Draft is merely a working draft and that it lacks many of the important details contained in the broader FIRPTA reforms of both the Administration's

[24] The Treasury Department's General Explanation of these proposals is available here: http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf. In connection with this proposal, the White House issued a press release, available here: http://www.whitehouse.gov/the-press-office/2013/03/29/rebuild-america-partnership-president-s-plan-encourage-private-investmen; in which it stated the following:

> Under current law, gains of foreign investors from the disposition of U.S. real property interests are generally subject to U.S. tax under FIRPTA, and foreign investors, including large foreign pension funds, regularly cite FIRPTA as an impediment to their investment in U.S. infrastructure and real estate assets. With U.S. pension funds generally exempt from U.S. tax upon the disposition of U.S. real property investments, the Administration proposes to put foreign pension funds on an approximately equal footing: exempting their gains from the disposition of U.S. real property interests, including infrastructure and real estate assets, from U.S. tax under FIRPTA.

proposal and S. 1181. Therefore, NAREIT suggests that any final legislation addressing these issues should look to the complete approach taken by the Administration's proposal and S. 1181.

b. Discussion Draft's Attribution Rules Could Inappropriately Deem a U.S. REIT's Virtually Wholly-Owned Subsidiary REIT to be Foreign-Controlled

Under current law, a DCQIE is defined as a REIT or mutual fund with respect to which foreign persons directly or indirectly hold less than 50% of the value of the REIT or mutual fund. The Discussion Draft's proposal would replace the directly or indirectly test by instead applying the attribution rules in section 318. We assume that the underlying policy concern remains the direct or indirect ownership of a REIT by foreign persons, but that this language itself was thought too vague as an operational rule.

There are four sets of attribution rules in section 318(a): family attribution rules in (a)(1); entity-to-owner attribution rules in (a)(2); owner-to-entity attribution rules in (a)(3); and option attribution rules in (a)(4).

Although NAREIT appreciates the Finance Committee's reasons for suggesting the application of attribution rules, NAREIT first notes that, particularly in the case of widely held SEC-registered and/or stock exchange-listed REITs, section 318's attribution rules would be overly broad and virtually impossible to administer accurately. Thus, because these REITs would face uncertainty in evaluating their domestically controlled status, the application of these attribution rules would impede foreign investment in REITs. Second, NAREIT suggests that it does not make sense to apply the family attribution rules to determine whether a QIE is domestically controlled. If a U.S. person owns stock in a QIE, there is no logical reason to re-attribute that stock to a foreign relative of the U.S. owner or vice versa. Furthermore, such a rule would be extremely difficult to administer.

NAREIT also suggests that it does not make sense to apply the owner-to-entity attribution rules. As noted above, there are many situations in which an SEC-registered and/or stock exchange-listed REIT may own a majority or all of the interests in a foreign corporation (electing TRS status) and also a majority interest in a subsidiary REIT, with the remainder of the subsidiary REIT being owned by foreign persons. The attribution rules in section 318(a)(3) would cause the foreign TRS to be deemed to own the parent REIT's interest in the subsidiary REIT, thereby causing the subsidiary REIT not to be considered domestically controlled—not because of its actual foreign ownership, but through its actual U.S. ownership.[25]

[25] In terms of illustration, assume REIT Inc., a publicly traded U.S. REIT, has acquired 99% of a formerly publicly traded U.S. REIT, known as REIT 2 Inc. REIT 2 Inc.'s remaining 1% is owned by foreign persons. REIT Inc. also owns properties overseas, and, in connection with such ownership, REIT Inc. owns 100% of TRS, a foreign corporation which has made a TRS election. If section 318(a)(3) applied to determine whether REIT 2 Inc. were a domestically controlled REIT, because 50% or more of the stock in TRS is owned by REIT Inc., TRS is considered as owning the stock (in REIT 2 Inc.) owned by REIT Inc. Thus, even though REIT 2 Inc. is in fact almost entirely owned by U.S. persons, applying section 318(a)(3) would treat it as not domestically controlled because its sister company is a foreign company.

Accordingly, NAREIT suggests that, if Congress decides to use constructive ownership rules for QIEs, section 897(h)(4) should apply only the attribution rules of sections 318(a)(2) (attribution **from** partnerships, estates, trusts, and corporations) and 318(a)(4) (certain options).

c. REITs Listed on U.S. Stock Exchanges Should Be Permitted to Presume Less-Than 5% Shareholders are U.S. Persons for purposes of "Domestically Controlled" Test

Current law appropriately does not apply the FIRPTA regime to sales of stock in a DCQIE because it is primarily owned by U.S. persons, *i.e.*, at least 50% U.S. ownership.[26] This rule works well for private REITs and private mutual funds since they know the identity of their shareholders and can monitor whether foreign owners collectively cross the 50% threshold disqualifying the REIT or mutual fund as a DCQIE. For stock exchange-listed REITs, however, it is difficult if not impossible to track each and every owner because a number of shares that are traded on an established securities market are in "street name."

The Code has recognized the problem of identifying public shareholders in both the net operating loss limitations in section 382 and in the REIT subchapter.[27] The Securities Exchange Act of 1934 requires shareholders owning 5% or more of an SEC-registered company to timely file ownership notices with the SEC that are publicly available. Both of these tax sections allow an SEC-registered company to rely on the filings in measuring stock ownership in their particular circumstance. Similarly, for purposes of determining whether a regularly traded REIT is a DCQIE, the law should be clarified so that only persons who own 5% or more of a U.S. stock exchange-listed REIT's or mutual fund's stock are to be taken into account in calculating whether foreign shareholders own more than 50% of the stock.

Both H.R. 2870 and S. 1181 contain a provision that many believe would allow a stock exchange-listed REIT to presume that less-than-5% shareholders are U.S. persons for purposes of the domestically controlled REIT determination. This provision would modify section 897(h)(4) as follows:

> (c) In determining whether a qualified investment entity is domestically controlled, any stock in the qualified investment entity held by another qualified investment entity shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled. ***In making such a determination***, a qualified investment entity shall be permitted to presume that stock held by a holder of less than 5 percent of a class

[26] The qualified investment entity rules had long applied to "domestically controlled REITs" and were extended to mutual funds in 2004 for three years. The Emergency Economic Stabilization Act enacted in October 2008 extended these rules for mutual funds through December 31, 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, enacted December 17, 2010, extended these rules through December 31, 2011, and the American Taxpayer Relief Act of 2012, enacted on January 2, 2013, extended these rules through December 31, 2013.

[27] *See* I.R.C. §§ 382(g)(4), 856(d)(3)(flush language); *see also* Treas. Reg. § 1.382-2T(k)(1)(i).

> of stock regularly traded on an established securities market in the United States is held by United States persons throughout the testing period except to the extent that the qualified investment entity has actual knowledge regarding stock ownership.

(Emphasis added).

In order to provide certainty to foreign investors, the stock exchange-listed REITs in which they may invest, and the IRS regarding whether a stock exchange-listed REIT is in fact domestically controlled, NAREIT recommends that such a provision be enacted.

2. The Discussion Draft's Deemed Repatriation Rule and Minimum Taxation of Foreign Income Rules Should Not Apply to REITs

The Discussion Draft provides a transition rule that essentially would impose a 20% U.S. tax on accumulated deferred earnings of a CFC as of the effective date, with the ability to pay the associated tax liability over multiple years. Further, both Options Y and Z would impose some minimum U.S. tax on undistributed earnings of CFCs. Option Y essentially would impose a minimum tax of 80% of the U.S. corporate tax rate on low-taxed foreign income,[28] or Option Z would impose 60% of the U.S. corporate tax rate on CFCs' active foreign income and 100% of the U.S. corporate rate on a CFC's remaining (Subpart F) income.

In all cases, these proposals would result in adverse effects for U.S. REITs and their shareholders that are inconsistent with the rationale behind the policy of using a REIT as a way in order to make investment grade real estate available to investors from all walks of life. As noted above, although the U.S. tax rules and market pressures make the general goal of most REITs operating overseas is to generate the maximum amount of immediate income for distribution to shareholders as taxable dividends, there are extenuating circumstances (*e.g.,* foreign corporate law) that may prevent those REITs from being able to repatriate those foreign earnings.

To the extent that a REIT invests overseas through corporations (CFCs), which it may do on a limited basis to ensure satisfaction of the REIT Gross Income and Asset Tests, deeming the earnings of such CFCs to be immediately included in the REIT's taxable income results may result in: 1) phantom income (which would apply to all U.S. REIT shareholders), 2) uncertainty as to the characterization of this phantom income for purposes of the REIT Gross Income Test[29];

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[28] As noted above, REITs may invest outside of the U.S. through fiscally transparent entities that are regarded entities for foreign purposes in order to maximize distributions to U.S. shareholders. The reason for this type of structure is because a REIT cannot make effective use of the foreign tax credit. The typical structure may utilize a lending or holding company in a low-tax treaty jurisdiction. Because the Discussion Draft proposes that a tax rate less below 80% of the U.S. corporate tax rate would be a "low tax rate," the corporate tax rates in many countries could be treated as "low." As a result, a REIT may have CFCs with low-taxed foreign income that would be subject to a minimum U.S. corporate tax under the Discussion Draft.

[29] Further, to the extent that this income were not considered qualified 75% Gross Income, but were considered either qualified 95% Gross Income or non-qualifying income, its inclusion in the REIT's gross income could affect the REIT's calculation and satisfaction of the Gross Income Tests, which could jeopardize the REIT's status. In

3) a tax liability without associated cash to pay the liability; and, 4) presumably, a requirement that the REIT distribute at least 90% of this phantom income (which would not apply to all taxpayers). To the extent that the REIT retained up to 10% of this income, it would be required to pay tax on such income.[30] Because failure to distribute phantom income could result in loss of REIT status, REITs would be forced to issue new stock, sell assets or borrow money, none of which necessarily would be in the long term best interests of shareholders. Furthermore, REIT shareholders generally would not be paying tax on the distributions of the phantom income at the lower tax rate applicable to qualified dividends. A further issue for REITs would be whether the phantom income from the Transition Rule or the Minimum Taxation Rule would be considered as qualifying income under either the 75% or 95% Gross Income Tests.

Accordingly, NAREIT recommends that the Discussion Draft be amended so that the Transition Rule and the Minimum Taxation Rule not apply to REITs. As a general matter, it appears that a number of the issues highlighted in this letter would be mitigated if the Subpart F rules were modernized to allow the activities of employees of closely related companies (*e.g.,* sister companies or parent-subsidiary companies related by at least 25% stock ownership) to be considered activities of the employees of the real estate holding entity for purposes of the FPHCI rules, and NAREIT recommends that you consider such a change. As noted earlier, local employment laws and practices often require that the individuals operating and managing a specific foreign property be employed by a separate property manager affiliate in the group rather than the real estate holding entity.[31] In addition to this change, it would be helpful for legislative confirmation that these Subpart F inclusions would be qualified income for purposes of the 95% Gross Income Test or ignored until repatriated for REIT Gross Income Test purposes.

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other words, the additional phantom income would mean that the REIT has a greater amount of total gross income; thus, unless its amount of 75% Gross Income also were to increase, such income would comprise a smaller percentage of the REIT's total gross income. If it were to make up less than 75% of the REIT's gross income, the REIT would fail the 75% Gross Income Test. Even allowing for the payment of increased U.S. tax liability due to deemed repatriation of foreign earnings to be deferred over eight years as proposed by the Discussion Draft is of no benefit to a REIT that has both phantom income and a skewed Gross Income Test due to nonqualifying phantom income. The Discussion Draft proposes a partial deduction for certain deemed-repatriated foreign income. One potential solution to some of the adverse effects to REITs described in this letter would be to allow REITs to exclude, rather than deduct, this income.

[30] As noted above, I.R.C. § 857(e)(2) allows a REIT to retain (and, thus, pay tax on) a type of phantom income called "excess noncash income." While this type of income is not subject to the 90% Distribution Requirement, the REIT must pay tax on the income. Thus, if the Transition Rule were not amended to exclude REITs, at the very least, the phantom income resulting from the Transition Rule should be considered excess noncash income.

[31] *See also* Letter by Mary C. Bennett, Esq. to Philip R. West, Esq., Deputy International Tax Counsel, Department of the Treasury (March 24, 1997), 97 TNT 74-22, *reprinted in* TAX NOTES TODAY (April 17, 1997) (noting the operational difficulties for commercial real estate groups under the subpart F rules from the requirement that each property company manage their properties through their "own employees" and proposing a number of solutions). Note that Section 5 of Discussion Draft Option Y would make similar changes with respect to "qualified banking or financing income" of an eligible CFC by deeming the activities of employees of a related corporation those of the original corporation in certain cases. Section 1 of Discussion Draft Option Z would make a similar change with respect to such income, but not with respect to rental income generated by a related corporation's employees.

3. Repeal of Check-the-Box Rules for Disregarded Entities of Controlled Foreign Corporations Should Not Apply to REITs

The Discussion Draft proposes to treat disregarded entities (DEs) of a CFC as corporations (in effect, a Deemed Incorporation Rule). It appears that this proposal is designed to target planning techniques that rely upon transactions that are currently not fiscally recognized between the CFC and the disregarded entities in order to manipulate various international tax rules. However, as described below, the proposed method of addressing these planning techniques would have unintended and adverse consequences for REITs investing overseas.

As discussed above, a REIT may own properties overseas through a foreign corporate entity and then use a wholly-owned foreign service company to employ the staff to manage and operate the rental real estate in order to satisfy local employment laws or practices. By electing to treat the service company as a disregarded entity for U.S. tax purposes, the staff is treated as employees of the parent company, thereby allowing the REIT to be treated as engaged in the active conduct of a trade or business of rental real estate under the Subpart F rules. Doing so avoids the uncertainty of income inclusion of passive rents under the Subpart F rules for Gross Income Test purposes. The REIT otherwise would be able to satisfy the active rent rules but for the need to employ the staff in a wholly-owned subsidiary due to local laws or practices. Though the staff of the service company should be viewed as the employees of its parent company, the pertinent regulation only allows the officers and employees of the real estate holding entity to be taken into account. We believe that this rule should be revised to allow employees of close affiliates to be taken into account for these purposes, which is both a practical approach and would simplify the planning for REITs investing overseas.

Similarly, a REIT with operations overseas may form a parent TRS to provide services to the tenants of the REIT, and the parent TRS may form local companies in each country in a region to satisfy local laws or practices. In order to have a single entity for U.S. tax purposes, the parent TRS will elect to treat the local service companies as disregarded entities to avoid the complications of having corporate subsidiaries in the structure for US tax purposes. Third, REITs which hold real estate overseas through a TRS structure may hold multiple properties in a group of companies because project lenders often will require that each property be held in a separate ownership vehicle. This vehicle can be structured as a disregarded subsidiary of the parent TRS of the group for both administrative convenience and to avoid the uncertainty of the application of the Subpart F rules. These practical structures would also be affected by the subject proposal. These common structures do not implicate the tax policy concerns behind the subject proposal and we request that the unintended impact on REITs be addressed by excluding REITs from the change or tailoring the corrective measure in a manner that does not impact such planning by REITs.

While the Deemed Incorporation Rule should have no effect on a REIT's foreign investments currently structured as corporations or tiers of corporations, the implementation of the proposal raises a number of issues for REITs that invest overseas through CFCs that own fiscally transparent entities.

First, the Deemed Incorporation Rule presumably would be treated as a section 351 incorporation transaction. There may be "boot" on the transaction, for example, liabilities exceeding basis. The characterization of this boot for purposes of the REIT gross income tests is unclear and could affect REIT qualification.

Second, to the extent that this income is considered Subpart F income (and/or active income subject to minimum U.S. tax under the Discussion Draft), the REIT again would have phantom income required to be distributed without the corresponding cash to distribute. Additionally, the characterization of this phantom income for purposes of the REIT Gross Income Tests is not addressed by the Discussion Drafts.

Third, currently disregarded loans to foreign disregarded entities would become "regarded" loans that could result in additional 95% Gross Income to the REIT, if unsecured, again potentially affecting its REIT qualification.

Fourth, the deemed incorporation may also result in phantom gain recognition under section 367 if the operations do not qualify for the active trade or business exception which may not be available if the employees are in a related management company.

In addition to the Deemed Incorporation Rule proposed in the Discussion Draft, the Committee has requested comments regarding the current treatment of foreign branches. As described herein, U.S. REITs do invest overseas through foreign DEs. To the extent that the Committee may be considering requiring some type of deemed incorporation of foreign branches (similar to that proposed by the House Ways and Means Committee in its International Tax Reform Discussion Draft), we have been advised that the transition from DE to CFC/TRS status could be extremely detrimental to REITs because a deemed outbound transfer of assets would occur. Most likely the exceptions contained in section 367(a) would not be met, causing the outbound transfer to result in full recognition of the built-in gain in any real estate held in a foreign DE. Furthermore, most REITs rely on the method contained in 1991 proposed regulations for maintaining their section 987 pools, so that the deemed outbound transfer would result in a triggering of any built-in currency gain or loss inherent in their non-U.S. functional currency investments. Without any mechanism to address the potential tax impact of the deemed outbound transfer of assets, REITs could have a tremendous amount of non-cash income which could affect their ability to meet their distribution requirements.

Because of the various issues raised by the Deemed Incorporation Rule, we recommend that the Discussion Draft be modified to exclude REITs from this rule.

4. Discussion Draft's Effective Repeal of Portfolio Interest Rule Except for Reciprocal Treaty Countries Would Hamper Real Estate Industry's Continued Economic Recovery

Nonresident aliens and foreign corporations are generally subject to a 30% gross-basis withholding tax on their U.S. source interest income. However, under sections 871(h) and 881(c), a zero percent withholding tax applies to "portfolio interest", interest (including original

issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that it is not a U.S. person.

The Discussion Draft effectively would make the portfolio interest exception in respect of interest on corporate debt available only to residents of other countries when U.S. residents are eligible for similar exemptions under U.S. income tax treaties with those countries. NAREIT recommends that this proposal not be enacted for three reasons. First, as the real estate industry continues its slow economic recovery, limiting its ability to obtain capital through debt offerings to residents in countries that may not allow for reduced withholding under treaties (even though such countries may have some type of "portfolio interest" exemption and/or that allow for structuring that effectively reduces interest withholding on payments out of that country) would be unwise. Providing the greatest access to **both** the foreign debt and capital markets would assist in providing the needed capital to refinance loans, make needed improvements, and develop properties.[32]

Second, under the current portfolio interest rule, a foreign investor is not required to provide a U.S. taxpayer identification number to obtain a zero percent withholding rate. Conversely, under the zero withholding interest rules under tax treaties, foreign investors who want to avail themselves of the exemption must furnish the U.S. borrower (or intermediary) with U.S. taxpayer identification numbers.[33] Several of our members have raised concerns with this proposed repeal, noting that many foreign investors would not invest in U.S. debt obligations if they needed first to secure an identification number from the IRS for a purely portfolio investment (even though they would qualify for zero withholding under a treaty). At the very least, NAREIT recommends that the proposal should exempt publicly offered debt from the repeal of the portfolio interest exception because of the inherent transparency and availability of information with respect to such debt.

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[32] Foreign investors make up a sizable percentage of the investors in U.S. corporate bonds. According to a report issued by the Federal Reserve (Federal Reserve Statistical Release, dated December 9, 2013, and available here: http://federalreserve.gov/releases/z1/Current/z1.pdf), foreign investors accounted for 30% of the cumulative net issuance of U.S. corporate bonds between 1990-2007, and 36% of the cumulative issuance between 2003-2007, which was a period of particularly strong market activity. Foreign investors were slow to return to corporate bonds during and after the crisis, but have bought 25% of total net issuance for the first three quarters of 2013.

[33] The preamble to the regulations under section 1441, T.D. 8734, 62. F.R. 53387-498 (October 14, 1997), provides that a U.S. taxpayer identification number is not necessary to claim the portfolio interest exemption. ("As in the proposed regulations, a [U.S. taxpayer identification number] is not required to be stated on a Form W-8 used to claim the benefit of the portfolio interest exemption, regardless of whether the debt obligation is publicly traded.") Treas. Reg. § 1.1441-1(e)(4)(vii) provides a list of withholding certificates for various income items with respect to which a U.S. taxpayer identification number is required. This list includes "[a] withholding certificate on which a beneficial owner is claiming the benefit of a reduced rate under an income tax treaty (other than for amounts described in section 1.1441-6(c)(2))," but, notably, the list does not include a withholding certificate on which an investor is claiming an exemption under the portfolio interest exemption. (Treas. Reg. § 1.1441-6(c)(2) does not require a U.S. taxpayer identification number for, among other things, interest on actively traded debt obligations. However, many debt obligations that generate portfolio interest eligible for the portfolio interest exemption may not be actively traded.) In addition, IRS Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding" only requires inclusion of a U.S. taxpayer identification number under Part II, "Claim of Treaty Benefits."

Thank you for the opportunity to provide these comments. Please contact me at (202) 739-9408 or tedwards@nareit.com or Dara Bernstein, NAREIT's Senior Tax Counsel at (202) 739-9446 or dbernstein@nareit.com, if you would like to discuss this letter in greater detail.

Respectfully submitted,

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cc: The Honorable Orrin Hatch