NATIONAL
ASSOCIATION
OF
REAL ESTATE
INVESTMENT
TRUSTS®

♦ ♦ ♦

REITs:
BUILDING
DIVIDENDS
AND
DIVERSIFICATION®

April 15, 2016

VIA ELECTRONIC SUBMISSION [Notice.Comments@irscounsel.treas.gov]

Internal Revenue Service
CC:PA:LPD:PR (Notice 2016-23)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2016-23: Request for Comments Regarding Implementation of the New Partnership Audit Regime Enacted as Part of the Bipartisan Budget Act of 2015

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity to offer our suggestions with respect to the Treasury Department and Internal Revenue Service's Notice 2016-23, request for comments regarding the implementation of the Bipartisan Budget Act of 2015 (the BBA), which reformed the partnership audit and collection process.

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.

## EXECUTIVE SUMMARY

NAREIT appreciates the opportunity to provide our perspective regarding forthcoming guidance in this area, and urges the Treasury Department and IRS to take into account the comments described below.[1] The BBA sets out two avenues by which adjustment items properly allocable to partners may be recognized at the partner level rather than at the partnership level under the new audit rules. The BBA also sets out rules related to the calculation of interest amounts due.

NAREIT requests guidance confirming that when a REIT is a partner in a partnership subject to the new audit provisions, the partner REIT may use the

[1] NAREIT echoes the comments submitted by The Real Estate Roundtable dated April 13, 2016 that encourage a broad interpretation of the alternatives to partnership level assessment and acknowledge the improvements incorporated in the BBA throughout the legislative process.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

existing deficiency dividend procedures set out in section 860[2] with respect to any resulting adjustment to REIT taxable income arising from either: 1) the filing of a return by the REIT in accordance with new section 6225(c); or, 2) the calculation of the REIT's reviewed year adjusted taxable income under the alternative method set out in new section 6226. Also, NAREIT requests that the date of receipt by the REIT of a partnership statement with adjustment amounts be deemed the determination date for purposes of counting the 90-day deadline for making a deficiency distribution to shareholders under section 860(f)(1).

NAREIT also requests confirmation that any interest due with respect to adjustments under these provisions is determined under the existing deficiency dividend rules rather than under the partnership audit rules, and in all events, that the REIT does not bear double interest on a given deficiency.

Finally, NAREIT requests that guidance acknowledge Congressional intent that a REIT does not prevent an otherwise eligible partnership with 100 or fewer partners from being able to elect out of the new audit provisions and that the REIT, rather than the REIT shareholder, is counted as the partner for this purpose.

## DISCUSSION

### I. Background

REIT Investments through Partnerships, including UPREITs and DownREITs

Like most other real estate owners, REITs conduct a substantial part of their business through entities treated as partnerships for federal income tax purposes. Many publicly traded REITs hold substantially all of their assets through operating partnerships (OPs), the majority of the interests of which are held by the REIT. These REITs are known as umbrella partnership REITs, or UPREITs.[3]

An UPREIT generally consists of a publicly traded REIT that owns substantially all of its assets and conducts substantially all of its operations through an OP. As a general rule, the REIT will own a number of "units" in the OP equal to the number of shares of common stock that the REIT has outstanding. In addition to the UPREIT structure, there is a related "DownREIT" structure in which a REIT may invest some, but not all, of its assets in a lower-tier "DownREIT" partnership.

Both UPREITs and DownREITs often hold assets and conduct their businesses through multiple tiers of tax partnerships. For example, the OP in the UPREIT structure may enter into a joint

[2] Unless otherwise noted, 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.).
[3] *See* Treas. Reg. § 1.701-2(d), Ex. 4 (the partnership anti-abuse regulations), in which the Treasury Department used an example of an UPREIT to illustrate the type of non-abusive arrangement intended to be excluded by the regulations.

venture with an institutional investor to own and operate a portfolio of real estate assets. As a result, there are often multiple tiers of tax partnerships under the REIT.

REIT Taxation, Distributions, and the Deficiency Dividend Procedure

A REIT must satisfy several qualification tests including a requirement to distribute 90% of its "REIT taxable income" (excluding net capital gain) each year (the 90% Distribution Requirement).[4] Like a mutual fund, a REIT is allowed a dividends paid deduction in computing its taxable income.[5] Thus, a REIT does not pay corporate tax on distributed earnings (with most REITs usually distributing 100% of their taxable income because of market demands) and the tax burden from a REIT's business is borne by the REIT's shareholders. If the REIT distributes at least 90% but less than 100% of its REIT taxable income, tax will be incurred at the corporate level.

The deficiency dividend procedures, enacted forty years ago,[6] are a well-established set of rules with accompanying Treasury regulations and IRS forms that apply with respect to later-discovered adjustments to a REIT's prior year taxable income.[7] Congress expanded these rules to apply to regulated investment companies (RICs) in 1986[8] and to include self-determinations of adjustments by a REIT in 2004.[9]

The REIT rules permit a REIT to be "relieved from the payment of a deficiency in (or be allowed a credit or refund with respect to) certain income taxes that are determined by taking into account the deduction for dividends paid." [10] Generally, if a "determination" with respect to a REIT results in an "adjustment," for a taxable year, the REIT is permitted a deduction in the amount of the "deficiency dividend" for purposes of calculating the dividends paid deduction for the REIT's adjusted taxable year.[11]

The "determination" may be established one of several ways: 1) under a final court decision; 2) a closing agreement under section 7121; 3) an agreement signed by the Secretary and the REIT; or, 4) a self determination by the REIT evidenced by the filing of IRS Form 8927.[12]

---

[4] I.R.C. § 857(a)(1)(A). A limited exception from the 90% Distribution Requirement is available for certain types of "phantom" or "noncash" income recognized by a REIT. I.R.C. § 857(a)(1)(B).
[5] I.R.C. § 857(b)(2)(B).
[6] Tax Reform Act of 1976, Pub. L.No. 94-455, § 1601.
[7] I.R.C. § 860.
[8] Tax Reform Act of 1986, Pub. L.No. 99-514, §667(b)(1).
[9] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 243.
[10] T.D. 7936, 49 Fed. Reg. 2104, (Jan. 18, 1984) (Preamble to Final Regulations Concerning REIT Deficiency Dividends).
[11] I.R.C. § 860(a)(1).
[12] I.R.C. § 860(e). I.R.S. Form 8927, Determination Under Section 860(e)(4) by a Qualified Investment Entity. *See also* Rev. Proc. 2009-28, 2009-20 I.R.B. 1101, setting forth the circumstances under which the filing of Form 8927 is treated as a determination for purposes of section 860(e)(4).

The “adjustment” for REIT purposes is, generally, the increase in the REIT taxable income calculated without regard to the dividends paid deduction (with special rules for foreclosure property and to reflect changes in net capital gain).[13]

The REIT must pay the deficiency dividend within 90 days after the date of the “determination.” After distributing the deficiency dividend to the shareholders, the REIT files the “claim for deficiency” utilizing IRS Form 976, on which the REIT indicates the amount and tax year of the deficiency, how much of the deficiency was paid, the amount claimed as a deduction for deficiency dividends, and how the deficiency was established, among other factors. [14]

The deduction for the deficiency dividend applies to the taxable year to which the adjustment or determination applies. The amount of the deficiency dividend is taxable to the shareholder for the shareholder’s taxable year in which the distribution is made (not the year to which the adjustment or determination relates).[15]

The amount of the deficiency dividend is treated as an additional tax for purposes of the calculation of interest that is imposed on the REIT from the last date on which the REIT could have made a payment in the deficiency year to the date the claim for deficiency (Form 976) is filed.[16]

The example below, derived from examples in the legislative history to the provisions enacted in 1976, illustrates the operation and scope of the procedure.

> A calendar year REIT reports REIT taxable income of $100 (before taking into account the dividends paid deduction) in year one. The REIT distributes a $90 dividend to the REIT shareholders in year one. The REIT shareholders take the $90 REIT dividend into account in calculating their year one tax liabilities. The REIT has a dividends paid deduction equal to the distribution of $90 and $10 of taxable income remaining upon which it pays a corporate-level tax in year one.[17]
>
> In year three (either because of an audit or because of diligence on the part of the REIT), the REIT discovers that it overstated expenses by $10 in calculating its year one REIT taxable income. Generally, the REIT calculates its year one adjustment amount taking into consideration the reduced expenses under a specific formula set out in under §860(d)(2) which, in this case, would yield an adjustment of $10. Under the deficiency dividend procedures, the REIT may pay a deficiency dividend of up to $10 during year three. The $10 deficiency dividend exceeds the amount required to meet the income distribution requirement for year one (which would only require an additional $9

[13] I.R.C. § 860(d)(2).
[14] I.R.C. § 860(g); I.R.S. Form 976, Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust.
[15] *See* General Explanation of the Tax Reform Act of 1976, Staff of the Joint Committee on Taxation, p. 448.
[16] I.R.C. § 860(c)(1).
[17] As noted above, typically market forces demand REIT distributions greater than the 90% in this example.

distribution) and permits the REIT to pay a deficiency dividend sufficiently large so that it does not incur additional corporate income tax for year one (although the REIT will have to pay interest based on the $10).[18]

The deficiency dividend in this example would be paid in year three to the shareholders of the REIT and would be taken into account by the year three shareholders in the calculation of their year three tax liabilities. For shareholder tax reporting purposes, any resulting additional year one income would be included with the REIT's year three taxable income distribution and reflected on the REIT's year three Forms 1099-DIV furnished to shareholders. No additional collection procedure would be required.[19]

## II. The BBA and Adjustments to Partnership Level Imputed Underpayment

The new partnership audit procedures apply to all partnerships, but certain partnerships with 100 or fewer partners may elect out of the new procedures provided that all of the partners are of a specified type including individuals and C Corporations. Under the new partnership audit procedures, any tax attributable to audit adjustments at the partnership level in items of income, gain, loss, deduction, or credit will be determined, assessed, and collected at the partnership level. Congress provided two primary relief valves for a partnership level assessment.

New section 6225 permits the Secretary to establish procedures under which the partnership's imputed underpayment amount may be reduced by taking into account the impact of the underlying adjustments on the partners' reviewed year returns. For example, the provision contemplates adjustment for amounts allocable to tax-exempt partners or to partners who amend their reviewed year returns to reflect their properly allocable portion of the partnership's adjustments and pay any tax due.

Alternatively, under section 6226, if a partnership makes a timely election and furnishes to the Secretary and to each partner a statement with the partner's share of any adjustments to income, gain, loss, deduction, or credit in accordance with the notice of final partnership adjustment ("NOPA"), the burden shifts to the reviewed year partners to report the tax due in accordance with new procedures. Pursuant to this alternative method, the partners will include in their adjustment year tax return, an adjustment determined by calculating the amount by which their tax liability would have increased in the reviewed year (and subsequent years) if the partner's allocable share of the adjustments had been properly taken into account in the reviewed year.

[18] Likewise, if the REIT had paid $99 in year one, it would be able to pay a deficiency dividend of up to $10 for a total distribution of $109 even though the REIT did not need to use the deficiency dividend procedure to prevent disqualification. *See* S. Rep. No. 938, 94th Cong. 2d Sess. 464 note 4 (1976) and General Explanation of the Tax Reform Act of 1976, Staff of the Joint Committee on Taxation, p.446 note 4.

[19] Income reported on Form 1099 has been associated with high compliance rates. GAO Report to Committee on Finance, US Senate, Tax Refunds, June 2013, http://www.gao.gov/assets/660/655020.pdf , ("An IRS study of individual tax compliance found that in tax year 2006, taxpayers accurately reported over 90 percent of income with substantial information reporting requirements, such as interest and dividend income.") *citing*, IRS, Tax Gap for Tax Year 2006 Overview (Washington, D.C.: Jan. 6, 2012). http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf.

Under both of these methodologies, the partner will be permitted to recalculate the appropriate tax liability for a prior year with the partner's allocable share of the adjustments to income, gain, loss, deduction, or credit as set out in the NOPA. Congress anticipated that the deficiency dividend procedure would be used in connection with the new partnership audit rules.[20]

NAREIT requests that any guidance reflect that a REIT may continue to use the deficiency dividend procedures that have been in place for decades to make late-discovered adjustments to prior year tax returns, including when adjusting reviewed year amounts in accordance with the new procedures contemplated by sections 6225 and 6226.

For example, if the REIT in the hypothetical above discovered the $10 of excess expenses reported on the REIT's year one tax return via the receipt of a statement prepared by a partnership under new section 6226 indicating that the REIT's share of partnership expenses had been overstated by $10, the result of the example would be the same – the REIT would be permitted to make a distribution in year three of $10.

NAREIT requests guidance on how the new procedures contemplated by sections 6225 and 6226 apply in the context of multiple tiers of partnerships. In that situation, an upper-tier partnership should be allowed to pass through to its partners' adjustments flowing from a lower-tier partnership that has made the election under section 6226 with respect to adjustments at the lower-tier partnership level. We note that the Report of the Joint Committee on Taxation issued in connection with the BBA indicates that this result might be obtained by having the upper-tier partnership file a request for an administrative adjustment under section 6227 with respect to its distributive share of the lower-tier partnership adjustment.[21] Regardless of whether an adjustment originates at an upper-tier partnership or a lower-tier partnership or is reported to the REIT under the procedures of section 6226 or 6227, the REIT should be permitted to use the deficiency dividend procedures with respect to the partnership adjustment.

NAREIT also requests guidance clarifying the date of "determination" under section 860(f)(1) when the adjustment is communicated with an amended K-1 or statement of adjustment under the new partnership rules. The Treasury and IRS addressed a similar issue following the 2004 amendment of the deficiency dividend procedures to permit self-determination. Revenue Procedure 2009-29 provides that the date of "determination" for self-assessment is based on the date of mailing/receipt of the Form 8927 to the IRS by the REIT. In the case of adjustments communicated to the REIT by the partnership, NAREIT requests that the date of determination be the date that the communication is received by the partner REIT.

[20] General Explanation of Tax Legislation Enacted in 2015, Staff of the Joint Committee on Taxation, p. 70. "A recipient partner that is a RIC or REIT and that receives a statement from an audited partnership including adjustments for a prior (reviewed) year may wish to make a deficiency dividend with respect to the reviewed year. Guidance coordinating the receipt of a statement from an audited partnership by a RIC or REIT with the deficiency dividend procedures is expected to be issued by the Secretary."
[21] General Explanation of Tax Legislation Enacted in 2015, Staff of the Joint Committee on Taxation, p. 71.

Both the deficiency dividend rules and the new partnership audit rules specify procedures for the calculation of interest on adjustments attributable to a partner. NAREIT recommends that if the REIT partner makes a deficiency dividend, the interest be calculated in accordance with the deficiency dividend procedures and consistent with the existing method and reporting under section 860(c). The paramount element of this request is that whatever method is used to calculate interest, the REIT be subject to interest only once on any given adjustment amount.

Finally, NAREIT requests that guidance related to election out of the new rules recognize Congressional intent that a REIT is counted as only a single partner for purposes of determining eligibility to elect out under the 100-or-fewer partner rule.[22]

We would be pleased to discuss these comments if you believe it would be helpful. Please feel free to contact me at (202) 739-9408, or tedwards@nareit.com, Cathy Barré, NAREIT's Senior Vice President, Policy & Politics, at (202) 739-9422, or cbarre@nareit.com; or Dara Bernstein, NAREIT's Vice President and Senior Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

Tony M. Edwards
Executive Vice President and General Counsel

Cc: The Honorable Mark J. Mazur
The Honorable William J. Wilkins, Esq.
Julanne Allen, Esq.
Ossie Borosh, Esq.
Glenn Dance, Esq.
Rochelle Hodes, Esq.
Andrea Hoffenson, Esq.
Helen Hubbard, Esq.
Michael S. Novey, Esq.
David B. Silber, Esq.
Drita Tonuzi, Esq.
Cliff Warren, Esq.
Thomas West, Esq.
Curtis Wilson, Esq.

[22] General Explanation of Tax Legislation Enacted in 2015, Staff of the Joint Committee on Taxation, p. 58. "A C corporation partner that is a regulated investment company ("RIC") or a real estate investment trust ("REIT") does not prevent the partnership from being able to elect out, provided the applicable requirements are met."