Government Relations Committee Meeting

Tuesday, March 31st
3pm – 4:30pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Jeffrey Clark, SVP-Tax & JV Accounting, Host Hotels & Resorts

Panelists:
Andrea Hoffenson, Branch Chief-FI&P, IRS
Julanne Allen, Assistant to Branch Chief, IRS
Michael Novey, Associate Tax Legislative Counsel, Office of Tax Policy, US Treasury Department
Rohn Grazer, Managing Director-Tax, Prologis, Inc.
Dara Bernstein, Sr. Tax Counsel, NAREIT
Tony Edwards, EVP & General Counsel, NAREIT
Brian Wood, SVP & Chief Tax Officer, Ventas, Inc.

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REITS:

BUILDING

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AND

DIVERSIFICATION®

GOVERNMENT RELATIONS COMMITTEE MEETING
(Open to all REITWise® Registrants)
JW Marriott Desert Ridge Resort & Spa
Grand Sonoran G-K
Phoenix, AZ
Tuesday March 31, 2015
3:00 p.m. – 4:30 p.m.

Co-Chairs:

Jeffrey Clark, SVP-Tax & JV Accounting, Host Hotels & Resorts, Inc.
Rohn Grazer, Managing Director-Tax, Prologis, Inc.
Brian Wood, SVP & Chief Tax Officer, Ventas Inc.

Panelists:

Julanne Allen, Assistant to the Branch Chief, FI&P, IRS
Andrea Hoffenson, Branch Chief, FI&P, IRS
Michael Novey, Associate Tax Legislative Counsel, Department of the Treasury

NAREIT Staff Liaisons:

Tony Edwards, Executive Vice President & General Counsel
Dara Bernstein, Senior Tax Counsel

I. IRS and Treasury Department perspective

II. Tax reform developments

III. OECD's Base Erosion and Profit Shifting (BEPS) applicability to U.S. REITs' cross border investments

IV. FIRPTA reform update

V. U.S. REIT compliance with the EU's Alternative Investment Fund Managers Directive

VI. Main Street Fairness changes ahead?

VII. More fun items if there's time

Note: This meeting may qualify for 1.25 hours of continuing professional education credits, depending on the state. For CLE or CPE credit information, please contact Afia Nyarko at 202-739-9433 or anyarko@nareit.com.

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Issued in Kansas City, Missouri on May 7, 2014.

Timothy Smyth,

Acting Manager, Small Airplane Directorate, Aircraft Certification Service.

[FR Doc. 2014–11072 Filed 5–13–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–150760–13]

RIN 1545–BM05

Definition of Real Estate Investment Trust Real Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that clarify the definition of real property for purposes of the real estate investment trust provisions of the Internal Revenue Code (Code). These proposed regulations provide guidance to real estate investment trusts and their shareholders. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 12, 2014. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for September 18, 2014 must be received by August 12, 2014.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–150760–13), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–150760–13), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–150760–13). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Andrea Hoffenson, (202) 317–6842, or Julanne Allen, (202) 317–6945; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) Taylor, (202) 317–6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to real estate investment trusts (REITs). Section 856 of the Code defines a REIT by setting forth various requirements. One of the requirements for a taxpayer to qualify as a REIT is that at the close of each quarter of the taxable year at least 75 percent of the value of its total assets is represented by real estate assets, cash and cash items (including receivables), and government securities. See section 856(c)(4). Section 856(c)(5)(B) defines *real estate assets* to include real property and interests in real property. Section 856(c)(5)(C) indicates that *real property* means "land or improvements thereon." Section 1.856–3(d) of the Income Tax Regulations, promulgated in 1962, defines real property for purposes of the regulations under sections 856 through 859 as—

> land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term "real property" includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

Section 1.856–3(d).

The IRS issued revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for purposes of section 856. Specifically, the published rulings describe assets such as railroad properties,[1] mobile home units permanently installed in a planned community,[2] air rights over real property,[3] interests in mortgage loans secured by total energy systems,[4] and mortgage loans secured by microwave transmission property,[5] and the rulings address whether the assets qualify as either real property or interests in real property under section 856. Since these published rulings were issued, REITs have sought to invest in various types of assets that are not directly addressed by the regulations or the published rulings, and have asked for and received letter rulings from the IRS addressing certain of these assets. Because letter rulings are limited to their particular facts and may not be relied upon by taxpayers other than the taxpayer that received the ruling, see section 6110(k)(3), letter rulings are not a substitute for published guidance. The IRS and the Treasury Department recognize the need to provide additional published guidance on the definition of real property under sections 856 through 859. This document proposes regulations that define real property for purposes of sections 856 through 859 by providing a framework to analyze the types of assets in which REITs seek to invest. These proposed regulations provide neither explicit nor implicit guidance regarding whether various types of income are described in section 856(c)(3).[6]

Explanation of Provisions

Consistent with section 856, the existing regulations, and published guidance interpreting those regulations, these proposed regulations define *real property* to include land, inherently permanent structures, and structural components. In determining whether an item is land, an inherently permanent structure, or a structural component, these proposed regulations first test whether the item is a *distinct asset,* which is the unit of property to which the definitions in these proposed regulations apply.

In addition, these proposed regulations identify certain types of intangible assets that are real property or interests in real property for purposes of sections 856 through 859. These proposed regulations include examples to illustrate the application of the

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[1] Rev. Rul. 69–94 (1969–1 CB 189), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[2] Rev. Rul. 71–220 (1971–1 CB 210), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[3] Rev. Rul. 71–286 (1971–2 CB 263), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[4] Rev. Rul. 73–425 (1973–2 CB 222), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[5] Rev. Rul. 75–424 (1975–2 CB 269), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[6] One of the requirements for qualifying as a REIT is that a sufficiently large fraction of an entity's gross income be derived from certain specified types of income (which include "rents from real property" and "interest on obligations secured by mortgages on real property or on interests in real property"). Section 856(c)(3).

principles of these proposed regulations to determine whether certain distinct assets are real property for purposes of sections 856 through 859.

Distinct Asset

These proposed regulations provide that each distinct asset is tested individually to determine whether the distinct asset is real or personal property. Items that are specifically listed in these proposed regulations as types of buildings and other inherently permanent structures are distinct assets. Assets and systems specifically listed in these proposed regulations as types of structural components also are treated as distinct assets. Other distinct assets are identified using the factors provided by these proposed regulations. All listed factors must be considered, and no one factor is determinative.

Land

These proposed regulations define land to include not only a parcel of ground, but the air and water space directly above the parcel. Therefore, water space directly above the seabed is land, even though the water itself flows over the seabed and does not remain in place. Land includes crops and other natural products of land until the crops or other natural products are detached or removed from the land.

Inherently Permanent Structures

Inherently permanent structures and their structural components are real property for purposes of sections 856 through 859. These proposed regulations clarify that inherently permanent structures are structures, including buildings, that have a passive function. Therefore, if a distinct asset has an active function, such as producing goods, the distinct asset is not an inherently permanent structure under these proposed regulations. In addition to serving a passive function, a distinct asset must be inherently permanent to be an inherently permanent structure. For this purpose, permanence may be established not only by the method by which the structure is affixed but also by the weight of the structure alone.

These proposed regulations supplement the definition of inherently permanent structure by providing a safe harbor list of distinct assets that are buildings, as well as a list of distinct assets that are other inherently permanent structures. If a distinct asset is on one of these lists, either as a building or as an inherently permanent structure, the distinct asset is real property for purposes of sections 856 through 859, and a facts and circumstances analysis is not necessary. If a distinct asset is not listed as either a building or an inherently permanent structure, these proposed regulations provide facts and circumstances that must be considered in determining whether the distinct asset is either a building or other inherently permanent structure. All listed factors must be considered, and no one factor is determinative.

One distinct asset that these proposed regulations list as an inherently permanent structure is an outdoor advertising display subject to an election to be treated as real property under section 1033(g)(3). Section 1033(g)(3) provides taxpayers with an election to treat certain outdoor advertising displays [7] as real property for purposes of Chapter 1 of the Code.

Structural Components

These proposed regulations define a structural component as a distinct asset that is a constituent part of and integrated into an inherently permanent structure that serves the inherently permanent structure in its passive function and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. An entire system is analyzed as a single distinct asset and, therefore, as a single structural component, if the components of the system work together to serve the inherently permanent structure with a utility-like function, such as systems that provide a building with electricity, heat, or water.[8] For a structural component to be real property under sections 856 through 859, the taxpayer's interest in the structural component must be held by the taxpayer together with the taxpayer's interest in the inherently permanent structure to which the structural component is functionally related. Additionally, if a distinct asset that is a structural component is customized in connection with the provision of rentable space in an inherently permanent structure, the customization of that distinct asset does not cause it to fail to be a structural component.

Under these proposed regulations, an asset or system that is treated as a distinct asset is a structural component, and thus real property for purposes of sections 856 through 859, if the asset or system is included on the safe harbor list of assets that are structural components. If an asset or system that is treated as a distinct asset is not specifically listed as a structural component, these proposed regulations provide a list of facts and circumstances that must be considered in determining whether the distinct asset or system qualifies as a structural component. No one factor is determinative.

These proposed regulations do not retain the phrase "assets accessory to the operation of a business," which the existing regulations use to describe an asset with an active function that is not real property for purposes of the regulations under sections 856 through 859. The IRS and the Treasury Department believe that the phrase "assets accessory to the operation of a business" has created uncertainty because the existing regulations are unclear whether certain assets that are permanent structures or components thereof nevertheless fail to be real property because they are used in the operation of a business. Instead, these proposed regulations adopt an approach that considers whether the distinct asset in question either serves a passive function common to real property or serves the inherently permanent structure to which it is constituent in that structure's passive function. On the other hand, if an asset has an active function, such as a distinct asset that produces, manufactures, or creates a product, then the asset is not real property unless the asset is a structural component that serves a utility-like function with respect to the inherently permanent structure of which it is a constituent part. Similarly, if an asset produces or contributes to the production of income other than consideration for the use or occupancy of space, then that asset is not real property. Thus, items that were assets accessory to the operation of a business under the existing regulations will continue to be excluded from the definition of real property for purposes of sections 856 through 859 either because they are not inherently permanent or because they serve an active function. These distinct assets include, for example, machinery; office, off-shore drilling, testing, and other equipment; transportation equipment

[7] Section 1.1033(g)–1(b)(3) defines *outdoor advertising display* for purposes of the section 1033 election as "a rigidly assembled sign, display, or device that constitutes, or is used to display, a commercial or other advertisement to the public and is permanently affixed to the ground or permanently attached to a building or other inherently permanent structure."

[8] See Rev. Rul. 73–425 (1973–2 CB 222), (see § 601.601(d)(2)(ii)(*b*) of this chapter) (holding that a total energy system that provides a building with electricity, steam or hot water, and refrigeration may be a structural component of that building). The IRS and the Treasury Department are considering guidance to address the treatment of any income earned when a system that provides energy to an inherently permanent structure held by the REIT also transfers excess energy to a utility company.

that is not a structural component of a building; printing presses; refrigerators; individual air-conditioning units; grocery counters; furnishings of a motel, hotel, or office building; antennae; waveguides; transmitting, receiving, and multiplex equipment; prewired modular racks; display racks and shelves; gas pumps; and hydraulic car lifts.

Intangible Assets That Are Real Property

These proposed regulations also provide that certain intangible assets are real property for purposes of sections 856 through 859. To be real property, the intangible asset must derive its value from tangible real property and be inseparable from the tangible real property from which the value is derived. Under § 1.856–2(d)(3) the assets of a REIT are its gross assets determined in accordance with generally accepted accounting principles (GAAP). Intangibles established under GAAP when a taxpayer acquires tangible real property may meet the definition of real property intangibles. A license or permit solely for the use, occupancy, or enjoyment of tangible real property may also be an interest in real property because it is in the nature of an interest in real property (similar to a lease or easement). If an intangible asset produces, or contributes to the production of, income other than consideration for the use or occupancy of space, then the asset is not real property or an interest in real property. Thus, for example, a permit allowing a taxpayer to engage in or operate a particular business is not an interest in real property.

Other Definitions of Real Property

The terms real property and personal property appear in numerous Code provisions that have diverse contexts and varying legislative purposes. In some cases, certain types of assets are specifically designated as real property or as personal property by statute, while in other cases the statute is silent as to the meaning of those terms. Ordinarily, under basic principles of statutory construction, the use of the same term in multiple Code provisions would imply (absent specific statutory modifications) that Congress intended the same meaning to apply to that term for each of the provisions in which it appears. In the case of the terms real property and personal property, however, both the regulatory process and decades of litigation have led to different definitions of these terms, in part because taxpayers have advocated for broader or narrower definitions in different contexts.

For example, in the depreciation and (prior) investment tax credit contexts, a broad definition of personal property (and a narrow definition of real property) is ordinarily more favorable to taxpayers. A tangible asset may generally be depreciated faster if it is personal property than if it is considered real property, see section 168(c) and (g)(2)(C), and (prior) section 38 property primarily included tangible personal property and excluded a building and its structural components, see § 1.48–1(c) and (d). During decades of controversy, taxpayers sought to broaden the meaning of tangible personal property and to narrow the meanings of building and structural component in efforts to qualify for the investment tax credit or for faster depreciation. That litigation resulted in courts adopting a relatively broad definition of tangible personal property (and correspondingly narrow definition of real property) for depreciation and investment tax credit purposes.

Similarly, in the context of the Foreign Investment in Real Property Tax Act (FIRPTA), codified at section 897 of the Code, a narrower definition of real property is generally more favorable to taxpayers. Enacted in 1980, FIRPTA is intended to subject foreign investors to the same U.S. tax treatment on gains from the disposition of interests in U.S. real property that applies to U.S. investors. Accordingly, foreign investors can more easily avoid U.S. tax to the extent that the definition of real property is narrow for FIRPTA purposes. As in the depreciation and investment credit contexts, this situation has led to vigorous debate over the appropriate characterization of certain types of assets (such as intangible assets) that may have characteristics associated with real property but do not fall within the traditional categories of buildings and structural components. See, for example, Advance Notice of Proposed Rulemaking, Infrastructure Improvements Under Section 897, published in the **Federal Register** (REG–130342–08, 73 FR 64901) on October 31, 2008 (noting that taxpayers may be taking the position that a governmental permit to operate a toll bridge or toll road is not a United States real property interest for purposes of section 897 and stating that the IRS and the Treasury Department are of the view that such a permit may properly be characterized as a United States real property interest in certain circumstances). In the case of FIRPTA, however, Congress modified the definition of real property to include items of personal property that are associated with the use of real property. See section 897(c)(6)(B) (including as real property movable walls, furnishings, and other personal property associated with the use of the real property). Consequently, it is explicitly contemplated in section 897 that an item of property may be treated as a United States real property interest for FIRPTA purposes, notwithstanding that it is characterized as personal property for other purposes of the Code.

In the REIT context, taxpayers ordinarily benefit from a relatively broad definition of real property. Consequently, taxpayers have generally advocated in the REIT context for a more expansive definition of real property than applies in the depreciation, (prior) investment tax credit, and FIRPTA contexts. In drafting these regulations, the Treasury Department and the IRS have sought to balance the general principle that common terms used in different provisions should have common meanings with the particular policies underlying the REIT provisions. These proposed regulations define real property only for purposes of sections 856 through 859. The IRS and the Treasury Department request comments, however, on the extent to which the various meanings of real property that appear in the Treasury regulations should be reconciled, whether through modifications to these proposed regulations or through modifications to the regulations under other Code provisions.

Proposed Effective Date

The IRS and the Treasury Department view these proposed regulations as a clarification of the existing definition of real property and not as a modification that will cause a significant reclassification of property. As such, these proposed regulations are proposed to be effective for calendar quarters beginning after these proposed regulations are published as final regulations in the **Federal Register**. The IRS and the Treasury Department solicit comments regarding the proposed effective date.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13653. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on all aspects of these proposed rules. All comments will be available for public inspection and copying at *http://www.regulations.gov*, or upon request.

A public hearing has been scheduled for September 18, 2014, at 10:00 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by August 12, 2014. A period of ten minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Andrea M. Hoffenson and Julanne Allen, Office of Associate Chief Council (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** In § 1.856–3, paragraph (d) is revised to read as follows:

§ 1.856–3 Definitions.

* * * * *

(d) *Real property.* See § 1.856–10 for the definition of *real property.*

* * * * *

■ **Par. 3.** Section 1.856–10 is added to read as follows:

§ 1.856–10 Definition of real property.

(a) *In general.* This section provides definitions for purposes of part II, subchapter M, chapter 1 of the Internal Revenue Code (Code). Paragraph (b) of this section defines real property, which includes land as defined under paragraph (c) of this section, and improvements to land as defined under paragraph (d) of this section. Improvements to land include inherently permanent structures as defined under paragraph (d)(2) of this section, and structural components of inherently permanent structures as defined under paragraph (d)(3) of this section. Paragraph (e) of this section provides rules for determining whether an item is a distinct asset for purposes of applying the definitions in paragraphs (b), (c), and (d) of this section. Paragraph (f) of this section identifies intangible assets that are real property or interests in real property. Paragraph (g) of this section provides examples illustrating the rules of paragraphs (b) through (f) of this section.

(b) *Real property.* The term *real property* means land and improvements to land. Local law definitions are not controlling for purposes of determining the meaning of the term real property.

(c) *Land.* Land includes water and air space superjacent to land and natural products and deposits that are unsevered from the land. Natural products and deposits, such as crops, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land. The storage of severed or extracted natural products or deposits, such as crops, water, ores, and minerals, in or upon real property does not cause the stored property to be recharacterized as real property.

(d) *Improvements to land*—(1) *In general.* The term *improvements to land* means inherently permanent structures and their structural components.

(2) *Inherently permanent structure*—(i) *In general.* The term *inherently permanent structure* means any permanently affixed building or other structure. Affixation may be to land or to another inherently permanent structure and may be by weight alone. If the affixation is reasonably expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanent. A distinct asset that serves an active function, such as an item of machinery or equipment, is not a building or other inherently permanent structure.

(ii) *Building*—(A) *In general.* A building encloses a space within its walls and is covered by a roof.

(B) *Types of buildings.* Buildings include the following permanently affixed distinct assets: houses; apartments; hotels; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and stores.

(iii) *Other inherently permanent structures*—(A) *In general.* Other inherently permanent structures serve a passive function, such as to contain, support, shelter, cover, or protect, and do not serve an active function such as to manufacture, create, produce, convert, or transport.

(B) *Types of other inherently permanent structures.* Other inherently permanent structures include the following permanently affixed distinct assets: microwave transmission, cell, broadcast, and electrical transmission towers; telephone poles; parking facilities; bridges; tunnels; roadbeds; railroad tracks; transmission lines; pipelines; fences; in-ground swimming pools; offshore drilling platforms; storage structures such as silos and oil and gas storage tanks; stationary wharves and docks; and outdoor advertising displays for which an election has been properly made under section 1033(g)(3).

(iv) *Facts and circumstances determination.* If a distinct asset (within the meaning of paragraph (e) of this section) does not serve an active function as described in paragraph (d)(2)(iii)(A) of this section, and is not otherwise listed in paragraph (d)(2)(ii)(B) or (d)(2)(iii)(B) of this section or in guidance published in the Internal Revenue Bulletin (see

§ 601.601(d)(2)(ii) of this chapter), the determination of whether that asset is an inherently permanent structure is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(A) The manner in which the distinct asset is affixed to real property;

(B) Whether the distinct asset is designed to be removed or to remain in place indefinitely;

(C) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;

(D) Any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the distinct asset upon the expiration of the lease); and

(E) The time and expense required to move the distinct asset.

(3) *Structural components*—(i) *In general.* The term *structural component* means any distinct asset (within the meaning of paragraph (e) of this section) that is a constituent part of and integrated into an inherently permanent structure, serves the inherently permanent structure in its passive function, and, even if capable of producing income other than consideration for the use or occupancy of space, does not produce or contribute to the production of such income. If interconnected assets work together to serve an inherently permanent structure with a utility-like function (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component. Structural components are real property only if the interest held therein is included with an equivalent interest held by the taxpayer in the inherently permanent structure to which the structural component is functionally related. If a distinct asset is customized in connection with the rental of space in or on an inherently permanent structure to which the asset relates, the customization does not affect whether the distinct asset is a structural component.

(ii) *Types of structural components.* Structural components include the following distinct assets and systems: Wiring; plumbing systems; central heating and air conditioning systems; elevators or escalators; walls; floors; ceilings; permanent coverings of walls, floors, and ceilings; windows; doors; insulation; chimneys; fire suppression systems, such as sprinkler systems and fire alarms; fire escapes; central refrigeration systems; integrated security systems; and humidity control systems.

(iii) *Facts and circumstances determination.* If a distinct asset (within the meaning of paragraph (e) of this section) is not otherwise listed in paragraph (d)(3)(ii) of this section or in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter), the determination of whether the asset is a structural component is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(A) The manner, time, and expense of installing and removing the distinct asset;

(B) Whether the distinct asset is designed to be moved;

(C) The damage that removal of the distinct asset would cause to the item itself or to the inherently permanent structure to which it is affixed;

(D) Whether the distinct asset serves a utility-like function with respect to the inherently permanent structure;

(E) Whether the distinct asset serves the inherently permanent structure in its passive function;

(F) Whether the distinct asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure;

(G) Whether the distinct asset is installed during construction of the inherently permanent structure;

(H) Whether the distinct asset will remain if the tenant vacates the premises; and

(I) Whether the owner of the real property is also the legal owner of the distinct asset.

(e) *Distinct asset*—(1) *In general.* A distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure.

(2) *Facts and circumstances.* The determination of whether a particular separately identifiable item of property is a distinct asset is based on all of the facts and circumstances. In particular, the following factors must be taken into account:

(i) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;

(ii) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;

(iii) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and

(iv) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.

(f) *Intangible assets*—(1) *In general.* If an intangible asset, including an intangible asset established under generally accepted accounting principles (GAAP) as a result of an acquisition of real property or an interest in real property, derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space, then the intangible asset is real property or an interest in real property.

(2) *Licenses and permits.* A license, permit, or other similar right solely for the use, enjoyment, or occupation of land or an inherently permanent structure that is in the nature of a leasehold or easement generally is an interest in real property. A license or permit to engage in or operate a business generally is not real property or an interest in real property because it produces or contributes to the production of income other than consideration for the use or occupancy of space.

(g) *Examples.* The following examples demonstrate the rules of this section. *Examples 1* and *2* illustrate the definition of land as provided in paragraph (c) of this section. *Examples 3* through *10* illustrate the definition of improvements to land as provided in paragraph (d) of this section. Finally, *Examples 11* through *13* illustrate whether certain intangible assets are real property or interests in real property as provided in paragraph (f) of this section.

Example 1. Natural products of land. A is a real estate investment trust (REIT). REIT A owns land with perennial fruit-bearing plants. REIT A leases the fruit-bearing plants to a tenant on a long-term triple net lease basis and grants the tenant an easement on the land. The unsevered plants are natural products of the land and qualify as land within the meaning of paragraph (c) of this section. Fruit from the plants is harvested annually. Upon severance from the land, the harvested fruit ceases to qualify as land. Storage of the harvested fruit upon or within real property does not cause the harvested fruit to qualify as real property.

Example 2. Water space superjacent to land. REIT B leases a marina from a governmental entity. The marina is comprised of U-shaped boat slips and end ties. The U-shaped boat slips are spaces on the water that are surrounded by a dock on three sides. The end ties are spaces on the water at the end of a slip or on a long, straight dock. REIT B rents the boat slips and end ties to boat owners. The boat slips and end ties are water space superjacent to land that qualify as land within the meaning of paragraph (c) of this section and, therefore, qualify as real property.

Example 3. Indoor sculpture. (i) REIT C owns an office building and a large sculpture in the atrium of the building. The sculpture measures 30 feet tall by 18 feet wide and weighs five tons. The building was specifically designed to support the sculpture, which is permanently affixed to the building by supports embedded in the building's foundation. The sculpture was constructed within the building. Removal would be costly and time consuming and would destroy the sculpture. The sculpture is reasonably expected to remain in the building indefinitely. The sculpture does not manufacture, create, produce, convert, transport, or serve any similar active function.

(ii) When analyzed to determine whether it is an inherently permanent structure using the factors provided in paragraph (d)(2)(iv) of this section, the sculpture—

(A) Is permanently affixed to the building by supports embedded in the building's foundation;

(B) Is not designed to be removed and is designed to remain in place indefinitely;

(C) Would be damaged if removed and would damage the building to which it is affixed;

(D) Will remain affixed to the building after any tenant vacates the premises and will remain affixed to the building indefinitely; and

(E) Would require significant time and expense to move.

(iii) The factors described in this paragraph (g) *Example 3* (ii)(A) through (ii)(E) all support the conclusion that the sculpture is an inherently permanent structure within the meaning of paragraph (d)(2) of this section and, therefore, is real property.

Example 4. Bus shelters. (i) REIT D owns 400 bus shelters, each of which consists of four posts, a roof, and panels enclosing two or three sides. REIT D enters into a long-term lease with a local transit authority for use of the bus shelters. Each bus shelter is prefabricated from steel and is bolted to the sidewalk. Bus shelters are disassembled and moved when bus routes change. Moving a bus shelter takes less than a day and does not significantly damage either the bus shelter or the real property to which it was affixed.

(ii) The bus shelters are not enclosed transportation stations or terminals and do not otherwise meet the definition of a building in paragraph (d)(2)(ii) of this section nor are they listed as types of other inherently permanent structures in paragraph (d)(2)(iii)(B) of this section.

(iii) When analyzed to determine whether they are inherently permanent structures using the factors provided in paragraph (d)(2)(iv) of this section, the bus shelters—

(A) Are not permanently affixed to the land or an inherently permanent structure;

(B) Are designed to be removed and are not designed to remain in place indefinitely;

(C) Would not be damaged if removed and would not damage the sidewalks to which they are affixed;

(D) Will not remain affixed after the local transit authority vacates the site and will not remain affixed indefinitely; and

(E) Would not require significant time and expense to move.

(iv) The factors described in this paragraph (g) *Example 4* (iii)(A) through (iii)(E) all support the conclusion that the bus shelters are not inherently permanent structures within the meaning of paragraph (d)(2) of this section. Although the bus shelters serve a passive function of sheltering, the bus shelters are not permanently affixed, which means the bus shelters are not inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are not real property.

Example 5. Cold storage warehouse. (i) REIT E owns a refrigerated warehouse (Cold Storage Warehouse). REIT E enters into long-term triple net leases with tenants. The tenants use the Cold Storage Warehouse to store perishable products. Certain components and utility systems within the Cold Storage Warehouse have been customized to accommodate the tenants' need for refrigerated storage space. For example, the Cold Storage Warehouse has customized freezer walls and a central refrigeration system. Freezer walls within the Cold Storage Warehouse are specifically designed to maintain the desired temperature within the warehouse. The freezer walls and central refrigeration system are each comprised of a series of interconnected assets that work together to serve a utility-like function within the Cold Storage Warehouse, were installed during construction of the building, and will remain in place when a tenant vacates the premises. The freezer walls and central refrigeration system were each designed to remain permanently in place.

(ii) Walls and central refrigeration systems are listed as structural components in paragraph (d)(3)(ii) of this section and, therefore, are real property. The customization of the freezer walls does not affect their qualification as structural components. Therefore, the freezer walls and central refrigeration system are structural components of REIT E's Cold Storage Warehouse.

Example 6. Data center. (i) REIT F owns a building that it leases to a tenant under a long-term triple net lease. Certain interior components and utility systems within the building have been customized to accommodate the particular requirements for housing computer servers. For example, to accommodate the computer servers, REIT F's building has been customized to provide a higher level of electrical power, central air conditioning, telecommunications access, and redundancies built into the systems that provide these utilities than is generally available to tenants of a conventional office building. In addition, the space for computer servers in REIT F's building is constructed on raised flooring, which is necessary to accommodate the electrical, telecommunications, and HVAC infrastructure required for the servers. The following systems of REIT F's building have been customized to permit the building to house the servers: central heating and air conditioning system, integrated security system, fire suppression system, humidity control system, electrical distribution and redundancy system (Electrical System), and telecommunication infrastructure system (each, a System). Each of these Systems is comprised of a series of interconnected assets that work together to serve a utility-like function within the building. The Systems were installed during construction of the building and will remain in place when the tenant vacates the premises. Each of the Systems was designed to remain permanently in place and was customized by enhancing the capacity of the System in connection with the rental of space within the building.

(ii) The central heating and air conditioning system, integrated security system, fire suppression system, and humidity control system are listed as structural components in paragraph (d)(3)(ii) of this section and, therefore, are real property. The customization of these Systems does not affect the qualification of these Systems as structural components of REIT F's building within the meaning of paragraph (d)(3) of this section.

(iii) In addition to wiring, which is listed as a structural component in paragraph (d)(3)(ii) of this section and, therefore, is real property, the Electrical System and telecommunication infrastructure system include equipment used to ensure that the tenant is provided with uninterruptable, stable power and telecommunication services. When analyzed to determine whether they are structural components using the factors in paragraph (d)(3)(iii) of this section, the Electrical System and telecommunication infrastructure system—

(A) Are embedded within the walls and floors of the building and would be costly to remove;

(B) Are not designed to be moved, are designed specifically for the particular building of which they are a part, and are intended to remain permanently in place;

(C) Would not be significantly damaged upon removal and although they would damage the walls and floors in which they are embedded, they would not significantly damage the building if they were removed;

(D) Serve a utility-like function with respect to the building;

(E) Serve the building in its passive function of containing, sheltering and protecting computer servers;

(F) Produce income as consideration for the use or occupancy of space within the building;

(G) Were installed during construction of the building;

(H) Will remain in place when the tenant vacates the premises; and

(I) Are owned by REIT F, which also owns the building.

(iv) The factors described in this paragraph (g) *Example 6* (iii)(A), (iii)(B), and (iii)(D) through (iii)(I) all support the conclusion that the Electrical System and telecommunication infrastructure system are structural components of REIT F's building within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factor described in this paragraph (g) *Example 6* (iii)(C) would support a conclusion that the

Electrical System and telecommunication infrastructure system are not structural components. However this factor does not outweigh the factors supporting the conclusion that the Electric System and telecommunication infrastructure system are structural components.

Example 7. Partitions. (i) REIT G owns an office building that it leases to tenants under long-term triple net leases. Partitions are used to delineate space between tenants and within each tenant's space. The office building has two types of interior, non-load-bearing drywall partition systems: a conventional drywall partition system (Conventional Partition System) and a modular drywall partition system (Modular Partition System). Neither the Conventional Partition System nor the Modular Partition System was installed during construction of the office building. Conventional Partition Systems are comprised of fully integrated gypsum board partitions, studs, joint tape, and covering joint compound. Modular Partition Systems are comprised of assembled panels, studs, tracks, and exposed joints. Both the Conventional Partition System and the Modular Partition System reach from the floor to the ceiling.

(ii) Depending on the needs of a new tenant, the Conventional Partition System may remain in place when a tenant vacates the premises. The Conventional Partition System is designed and constructed to remain in areas not subject to reconfiguration or expansion. The Conventional Partition System can be removed only by demolition, and, once removed, neither the Conventional Partition System nor its components can be reused. Removal of the Conventional Partition System causes substantial damage to the Conventional Partition System itself but does not cause substantial damage to the building.

(iii) Modular Partition Systems are typically removed when a tenant vacates the premises. Modular Partition Systems are not designed or constructed to remain permanently in place. Modular Partition Systems are designed and constructed to be movable. Each Modular Partition System can be readily removed, remains in substantially the same condition as before, and can be reused. Removal of a Modular Partition System does not cause any substantial damage to the Modular Partition System itself or to the building. The Modular Partition System may be moved to accommodate the reconfigurations of the interior space within the office building for various tenants that occupy the building.

(iv) The Conventional Partition System is a wall, and walls are listed as structural components in paragraph (d)(3)(ii) of this section. The Conventional Partition System, therefore, is real property.

(v) When analyzed to determine whether it is a structural component using the factors provided in paragraph (d)(3)(iii) of this section, the Modular Partition System—

(A) Is installed and removed quickly and with little expense;

(B) Is not designed specifically for the particular building of which it is a part and is not intended to remain permanently in place;

(C) Is not damaged, and the building is not damaged, upon its removal;

(D) Does not serve a utility-like function with respect to the building;

(E) Serves the building in its passive function of containing and protecting the tenants' assets;

(F) Produces income only as consideration for the use or occupancy of space within the building;

(G) Was not installed during construction of the building;

(H) Will not remain in place when a tenant vacates the premises; and

(I) Is owned by REIT G.

(vi) The factors described in this paragraph (g) *Example 7* (v)(A) through (v)(D), (v)(G), and (v)(H) all support the conclusion that the Modular Partition System is not a structural component of REIT G's building within the meaning of paragraph (d)(3) of this section and, therefore, is not real property. The factors described in this paragraph (g) *Example 7* (v)(E), (v)(F), and (v)(I) would support a conclusion that the Modular Partition System is a structural component. These factors, however, do not outweigh the factors supporting the conclusion that the Modular Partition System is not a structural component.

Example 8. Solar energy site. (i) REIT H owns a solar energy site, among the components of which are land, photovoltaic modules (PV Modules), mounts, and an exit wire. REIT H enters into a long-term triple net lease with a tenant for the solar energy site. The mounts (that is, the foundations and racks) support the PV Modules. The racks are affixed to the land through foundations made from poured concrete. The mounts will remain in place when the tenant vacates the solar energy site. The PV Modules convert solar photons into electric energy (electricity). The exit wire is buried underground, is connected to equipment that is in turn connected to the PV Modules, and transmits the electricity produced by the PV Modules to an electrical power grid, through which the electricity is distributed for sale to third parties.

(ii) REIT H's PV Modules, mounts, and exit wire are each separately identifiable items. Separation from a mount does not affect the ability of a PV Module to convert photons to electricity. Separation from the equipment to which it is attached does not affect the ability of the exit wire to transmit electricity to the electrical power grid. The types of PV Modules and exit wire that REIT H owns are each customarily sold or acquired as single units. Removal of the PV Modules from the mounts to which they relate does not damage the function of the mounts as support structures and removal is not costly. The PV Modules are commonly viewed as serving the useful function of converting photons to electricity, independent of the mounts. Disconnecting the exit wire from the equipment to which it is attached does not damage the function of that equipment, and the disconnection is not costly. The PV Modules, mounts, and exit wire are each distinct assets within the meaning of paragraph (e) of this section.

(iii) The land is real property as defined in paragraph (c) of this section.

(iv) The mounts are designed and constructed to remain permanently in place, and they have a passive function of supporting the PV Modules. When analyzed to determine whether they are inherently permanent structures using the factors provided in paragraph (d)(2)(iv) of this section, the mounts—

(A) Are permanently affixed to the land through the concrete foundations or molded concrete anchors (which are part of the mounts);

(B) Are not designed to be removed and are designed to remain in place indefinitely;

(C) Would be damaged if removed;

(D) Will remain affixed to the land after the tenant vacates the premises and will remain affixed to the land indefinitely; and

(E) Would require significant time and expense to move.

(v) The factors described in this paragraph (g) *Example 8* (iv)(A) through (iv)(E) all support the conclusion that the mounts are inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are real property.

(vi) The PV Modules convert solar photons into electricity that is transmitted through an electrical power grid for sale to third parties. The conversion is an active function. The PV Modules are items of machinery or equipment and are not inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are not real property. The PV Modules do not serve the mounts in their passive function of providing support; instead, the PV Modules produce electricity for sale to third parties, which is income other than consideration for the use or occupancy of space. The PV Modules are not structural components of REIT H's mounts within the meaning of paragraph (d)(3) of this section and, therefore, are not real property.

(vii) The exit wire is buried under the ground and transmits the electricity produced by the PV Modules to the electrical power grid. The exit wire was installed during construction of the solar energy site and is designed to remain permanently in place. The exit wire is inherently permanent and is a transmission line, which is listed as an inherently permanent structure in paragraph (d)(2)(iii)(B) of this section. Therefore, the exit wire is real property.

Example 9. Solar-powered building. (i) REIT I owns a solar energy site similar to that described in *Example 8*, except that REIT I's solar energy site assets (Solar Energy Site Assets) are mounted on land adjacent to an office building owned by REIT I. REIT I leases the office building and the solar energy site to a single tenant. Although the tenant occasionally transfers excess electricity produced by the Solar Energy Site Assets to a utility company, the Solar Energy Site Assets are designed and intended to produce electricity only to serve the office building. The Solar Energy Site Assets were designed and constructed specifically for the office building and are intended to remain permanently in place but were not installed during construction of the office building. The Solar Energy Site Assets will not be removed if the tenant vacates the premises.

(ii) With the exception of the occasional transfers of excess electricity to a utility company, the Solar Energy Site Assets serve the office building to which they are constituent, and, therefore, the Solar Energy Site Assets are analyzed to determine whether they are a structural component using the factors provided in paragraph (d)(3)(iii) of this section. The Solar Energy Site Assets—

(A) Are expensive and time consuming to install and remove;

(B) Are designed specifically for the particular office building for which they are a part and are intended to remain permanently in place;

(C) Will not cause damage to the office building if removed (but the mounts would be damaged upon removal);

(D) Serve a utility-like function with respect to the office building;

(E) Serve the office building in its passive function of containing and protecting the tenants' assets;

(F) Produce income from consideration for the use or occupancy of space within the office building;

(G) Were installed after construction of the office building;

(H) Will remain in place when the tenant vacates the premises; and

(I) Are owned by REIT I (which is also the owner of the office building).

(iii) The factors described in this paragraph (g) *Example 9* (ii)(A), (ii)(B), (ii)(C) (in part), (ii)(D) through (ii)(F), (ii)(H), and (ii)(I) all support the conclusion that the Solar Energy Site Assets are a structural component of REIT I's office building within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factors described in this paragraph (g) *Example 9* (ii)(C) (in part) and (ii)(G) would support a conclusion that the Solar Energy Site Assets are not a structural component, but these factors do not outweigh factors supporting the conclusion that the Solar Energy Site Assets are a structural component.

(iv) The result in this *Example 9* would not change if, instead of the Solar Energy Site Assets, solar shingles were used as the roof of REIT I's office building. Solar shingles are roofing shingles like those commonly used for residential housing, except that they contain built-in PV modules. The solar shingle installation was specifically designed and constructed to serve only the needs of REIT I's office building, and the solar shingles were installed as a structural component to provide solar energy to REIT I's office building (although REIT I's tenant occasionally transfers excess electricity produced by the solar shingles to a utility company). The analysis of the application of the factors provided in paragraph (d)(3)(ii) of this section would be similar to the analysis of the application of the factors to the Solar Energy Site Assets in this paragraph (g) *Example 9* (ii) and (iii).

Example 10. Pipeline transmission system. (i) REIT J owns an oil pipeline transmission system that contains and transports oil from producers and distributors of the oil to other distributors and end users. REIT J enters into a long-term, triple net lease with a tenant for the pipeline transmission system. The pipeline transmission system is comprised of underground pipelines, storage tanks, valves, vents, meters, and compressors. Although the pipeline transmission system serves an active function, transporting oil, a distinct asset within the system may nevertheless be an inherently permanent structure that does not itself perform an active function. Each of these distinct assets was installed during construction of the pipeline transmission system and will remain in place when a tenant vacates the pipeline transmission system. Each of these assets was designed to remain permanently in place.

(ii) The pipelines and storage tanks are inherently permanent and are listed as inherently permanent structures in paragraph (d)(2)(iii)(B) of this section. Therefore, the pipelines and storage tanks are real property.

(ii) Valves are placed at regular intervals along the pipeline to control oil flow and isolate sections of the pipeline in case there is need for a shut-down or maintenance of the pipeline. Vents equipped with vent valves are also installed in tanks and at regular intervals along the pipeline to relieve pressure in the tanks and pipeline. When analyzed to determine whether they are structural components using the factors set forth in paragraph (d)(3)(iii) of this section, the valves and vents—

(A) Are time consuming and expensive to install and remove from the tanks or pipeline;

(B) Are designed specifically for the particular tanks or pipeline for which they are a part and are intended to remain permanently in place;

(C) Will sustain damage and will damage the tanks or pipeline if removed;

(D) Do not serve a utility-like function with respect to the tanks or pipeline;

(E) Serve the tanks and pipeline in their passive function of containing tenants' oil;

(F) Produce income only from consideration for the use or occupancy of space within the tanks or pipeline;

(G) Were installed during construction of the tanks or pipeline;

(H) Will remain in place when a tenant vacates the premises; and

(I) Are owned by REIT J.

(iii) The factors described in this paragraph (g) *Example 10* (ii)(A) through (ii)(C) and (ii)(E) through (ii)(I) support the conclusion that the vents and valves are structural components of REIT J's tanks or pipeline within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factor described in this paragraph (g) *Example 10* (ii)(D) would support a conclusion that the vents and valves are not structural components, but this factor does not outweigh the factors that support the conclusion that the vents and valves are structural components.

(iv) Meters are used to measure the oil passing into or out of the pipeline transmission system for purposes of determining the end users' consumption. Over long distances, pressure is lost due to friction in the pipeline transmission system. Compressors are required to add pressure to transport oil through the entirety of the pipeline. The meters and compressors do not serve the tanks or pipeline in their passive function of containing the tenants' oil, and are used in connection with the production of income from the sale and transportation of oil, rather than as consideration for the use or occupancy of space within the tanks or pipeline. The meters and compressors are not structural components within the meaning of paragraph (d)(3) of this section and, therefore, are not real property.

Example 11. Goodwill. REIT K acquires all of the stock of Corporation A, whose sole asset is an established hotel in a major metropolitan area. The hotel building is strategically located and is an historic structure viewed as a landmark. The hotel is well run by an independent contractor but the manner in which the hotel is operated does not differ significantly from the manner in which other city hotels are operated. Under GAAP, the amount allocated to Corporation A's hotel is limited to its depreciated replacement cost, and the difference between the amount paid for the stock of Corporation A and the depreciated replacement cost of the hotel is treated as goodwill attributable to the acquired hotel. This goodwill derives its value and is inseparable from Corporation A's hotel. If REIT K's acquisition of Corporation A had been a taxable asset acquisition rather than a stock acquisition, the goodwill would have been included in the tax basis of the hotel for Federal income tax purposes, and would not have been separately amortizable. The goodwill is real property to REIT K when it acquires the stock of Corporation A.

Example 12. Land use permit. REIT L receives a special use permit from the government to place a cell tower on federal government land that abuts a federal highway. Governmental regulations provide that the permit is not a lease of the land, but is a permit to use the land for a cell tower. Under the permit, the government reserves the right to cancel the permit and compensate REIT L if the site is needed for a higher public purpose. REIT L leases space on the tower to various cell service providers. Each cell service provider installs its equipment on a designated space on REIT L's cell tower. The permit does not produce, or contribute to the production of, any income other than REIT L's receipt of payments from the cell service providers in consideration for their being allowed to use space on the tower. The permit is in the nature of a leasehold that allows REIT L to place a cell tower in a specific location on government land. Therefore, the permit is an interest in real property.

Example 13. License to operate a business. REIT M owns a building and receives a license from State to operate a casino in the building. The license applies only to REIT M's building and cannot be transferred to another location. REIT M's building is an inherently permanent structure under paragraph (d)(2)(i) of this section and, therefore, is real property. However, REIT M's license to operate a casino is not a right for the use, enjoyment, or occupation of REIT M's building, but is rather a license to engage in the business of operating a casino in the building. Therefore, the casino license is not real property.

(h) *Effective/applicability date.* The rules of this section apply for calendar quarters beginning on or before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

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DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 243

[Docket ID: DOD–2013–OS–0130]

RIN 0790–AJ08

Ratemaking Procedures for Civil Reserve Air Fleet Contracts

AGENCY: USTRANSCOM, DoD.

ACTION: Proposed rule.

SUMMARY: Section 366 of the National Defense Authorization Act for Fiscal Year 2012 directs the Secretary of Defense to determine a fair and reasonable rate of payment for airlift services provided to the Department of Defense by air carriers who are participants in the Civil Reserve Air Fleet Program. The Department of Defense (the Department or DoD) proposes to promulgate regulations to establish ratemaking procedures for civil reserve air fleet contracts as required by Section 366(a) in order to determine a fair and reasonable rate of payment.

DATES: Comments must be received no later than July 14, 2014.

ADDRESSES: You may submit comments, identified by docket number and or Regulatory Information Number and title, by any of the following methods;

• *Federal eRulemaking Portal: http:// www.regulations.gov.* Follow the instructions for submitting comments.

• *Mail:* Federal Docket Management System Office, 4800 Mark Center Drive, 2nd Floor, East Tower, Suite 02G09, Alexandria, VA 22350–3100.

Instructions: All submissions received must include the agency name and docket number or RIN for this **Federal Register** document. The general policy for comments and other submissions from members of the public is to make these submissions available for public viewing on the Internet at *http:// www.regulations.gov* as they are received without change, including any personal identifiers or contact information.

FOR FURTHER INFORMATION CONTACT: Mr. Dwight Moore, Chief, Fiscal and Civil Law, USTRANSCOM/TCJA, (618) 220–3982 or Mr. Jeff Beyer, Chief, Business Support and Policy Division, USTRANSCOM/TCAQ, (618) 220–7021.

SUPPLEMENTARY INFORMATION:

Background

The Civil Reserve Air Fleet (CRAF) is a wartime readiness program, based on the Defense Production Act of 1950, as amended, (50 U.S.C. App. 2601 et seq.), and Executive Order 13603 (National Defense Resource Preparedness), March 16, 2012, to ensure quantifiable, accessible, and reliable commercial airlift capability to augment DoD airlift and to assure a mobilization base of aircraft available to the Department of Defense for use in the event of any level of national emergency or defense-orientated situations. As a readiness program, CRAF quantifies the number of passenger and cargo commercial assets required to support various levels of wartime requirements and thus allows DoD to account for their use when developing and executing contingency operations and war plans. In addition, the CRAF program identifies how DoD gains access to these commercial assets for operations by defining the authorities and procedures for CRAF activation. Finally, the program helps ensure that the DoD has reliable lines of communication and a common understanding of procedures with the carriers.

The United States Transportation Command (USTRANSCOM) negotiates and structures award of aircraft service contracts with certificated civilian air carriers willing to participate in the CRAF program in order to ensure that a mobilization base of aircraft is capable of responding to any level of defense-orientated situations.

The ability to set rates maintains the CRAF program's great flexibility to have any air carrier in the program able to provide aircraft within 24 hours of activation to fly personnel and cargo to any location in the world at a set rate per passenger or ton mile, regardless of where the air carrier normally operates. It also provides the Secretary of Defense the ability to respond rapidly to assist in emergencies and approved humanitarian operations, both in the United States and overseas where delay could result in more than monetary losses. The Government-set rate allows contracts to any location, sometimes awarded within less than an hour, and provides substantial commercial capability on short notice.

During the initial CRAF program years (between 1955 and 1962), ratemaking to price DoD airlift service relied upon price competition to meet its commercial airlift needs. This procurement method resulted in predatory pricing issues and failed to provide service meeting safety and performance requirements. Congressional Subcommittee hearings held at the time determined price competition to be non-compensatory and destructive to the industry. As a result, the ratemaking process was implemented under the regulatory authority of the Civil Aeronautics Board (CAB). Ratemaking continued under the CAB until deregulation in 1980. At that time, civil air carriers and DoD's contracting agency for long-term international airlift, the Military Airlift Command (MAC), agreed by a memorandum of understanding (MOU) that CAB methodologies by which rates for DoD airlift were established produced fair and reasonable rates and furthered the objectives of the CRAF program; and therefore, the parties agreed to continue to use CAB methodologies for establishing MAC uniform negotiated rates under an MOU renewed every five years. MAC became Air Mobility Command (AMC) on June 1, 1992. Ratemaking continued under AMC until January 1, 2007, when DoD's contracting authority for long-term international airlift was transferred from AMC to USTRANSCOM. On December 31, 2011, the National Defense Authorization Act for Fiscal Year 2012 (FY12 NDAA) was signed into law. Section 366 of the FY12 NDAA, codified at 10 U.S.C. § 9511a, authorized and directed the Secretary of Defense to determine a fair and reasonable rate of payment made to participants in the CRAF program. This proposed rulemaking effectuates Section 366.

This proposed rulemaking broadly tracks the longstanding ratemaking procedures for CRAF contracts in all substantial elements and the ratemaking methodologies supporting the pricing of airlift services as described in previous and current MOUs between certificated civilian air carriers willing to participate in the CRAF program and USTRANSCOM and USTRANSCOM predecessor entities.

In addition to compliance with this rule, CRAF participants, consistent with past practice, will be expected to enter into a MOU with USTRANSCOM where they will be expected to furnish USTRANSCOM, as a condition of its continued participation in the CRAF program, with the financial and operational information required by USTRANSCOM to adequately make a determination of fairness and reasonableness of price. This rulemaking will have no impact on air operators or certificated air carriers not

Private Letter Rulings for Government Relations Committee Meeting Discussion

I. Real Estate Assets/Rents from Real Property

A. Steel Racks:PLR 201503010 http://www.irs.gov/pub/irs-wd/201503010.pdf (steel racking structures are REIT-qualifying real property; payments from storage customers are qualifying rents from real property). PLR 201450017 http://www.irs.gov/pub/irs-wd/201450017.pdf (Electing REIT's fiber optic cable qualifies as a real estate asset)

B. Billboards: PLR 201450004 http://www.irs.gov/pub/irs-wd/201450004.pdf (sign structures and ancillary assets owned by a REIT qualify as "outdoor advertising displays" eligible for section 1033(g)(3) election under to be treated as real property for purposes of federal income taxation); PLR 201431018 http://www.irs.gov/pub/irs-wd/201431018.pdf (REIT earns qualifying rent from billboards); PLR 20143102 http://www.irs.gov/pub/irs-wd/201431020.pdf (REIT earns qualifying rent from billboards)

C. Harvestable Crops: PLR 201424017 http://www.irs.gov/pub/irs-wd/201424017.pdf (Plants that produce a harvestable crop constitute real property for REIT asset tests)

D. Cross-connectivity/"Remote Hands": PLR 201423011 http://www.irs.gov/pub/irs-wd/201423011.pdf (Cross-connectivity/"remote hands" services will not taint rental income; Subpart F, PFIC, CFC inclusions are 75% income)

II. Health Care Properties/Qualified Lodging Facilities

A. PLR 201505019 http://www.irs.gov/pub/irs-wd/201509019.pdf (senior housing property is "healthcare property").

B. PLR 201427001 http://www.irs.gov/pub/irs-wd/201427001.pdf (REIT's restructuring will not cause REIT or its taxable REIT subsidiary to be viewed as operating a health care facility)

C. PLR 201429017 http://www.irs.gov/pub/irs-wd/201429017.pdf (Senior living facilities are qualified health care properties)

III. Section 856(c)(5)(J)

A. PLR 201418022; http://www.irs.gov/pub/irs-wd/1418022.pdf (Section 856(c)(5)(J): income ignored; patronage dividends)

B. PLR 201418037 http://www.irs.gov/pub/irs-wd/1418037.pdf (Section 856(c)(5)(J): amounts received in tenant's bankruptcy would be either qualifying REIT income or excluded income)

C. PLR 201433005 http://www.irs.gov/pub/irs-wd/201433005.pdf (Patronage dividends under Section 856(c)(5)(J))

D. PLR 201429024 http://www.irs.gov/pub/irs-wd/201429024.pdf (On-site/nearby sports club not part of "qualified lodging facilities")

IV. Miscellaneous

A. PLR 201410029 http://www.irs.gov/pub/irs-wd/1410029.pdf (Accounting method change to reflect change in cost recovery period)

B. PLR 201446013 http://www.irs.gov/pub/irs-wd/201446013.pdf (Distribution of accumulated C corporation E&P was a dividend; adjustment to convertible debt conversion rate results in deemed dividend)

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105.—Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 856(c); 1.856-3, 1.856-5.)

Rev. Proc. 2014-51

SECTION 1. PURPOSE

This revenue procedure provides guidance regarding aspects of a taxpayer's qualification as a real estate investment trust (REIT) in the context of transactions involving debt secured by real estate the fair market value of which has declined. This revenue procedure modifies and supersedes Rev. Proc. 2011-16, 2011-5 I.R.B. 440, to address situations in which there is a subsequent increase in the value of real property securing a loan addressed in Rev. Proc. 2011-16. Section 2.14(4) of this revenue procedure describes the modifications made by this revenue procedure to Rev. Proc. 2011-16.

SECTION 2. BACKGROUND

.01 For an entity to qualify as a REIT for a taxable year, section 856(c)(4)(A) of the Internal Revenue Code requires that at the close of each quarter of its taxable year at least 75 percent of the value of the entity's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities (75% Asset Test). That is, the 75% Asset Test involves a fraction the denominator of which is the value of a REIT’s total assets and the numerator of which is the value of the REIT’s real estate assets, cash and cash items (including receivables), and Government securities.

.02 Under section 856(c)(5)(B), the term “real estate assets” includes real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.

.03 Section 856(c)(5)(C) provides that the term “interests in real property” includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests.

.04 Section 1.856-3(a) of the Income Tax Regulations defines the term “value” to mean “with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees of the real estate investment trust.”

.05 For an entity to qualify as a REIT for a taxable year, it must also satisfy two gross income tests.

(1) First, at least 95 percent of the entity's gross income must be derived from the types of income listed in section 856(c)(2) (95% Income Test). All interest is included as qualifying income for the 95% Income Test.

(2) Second, at least 75 percent of the entity's gross income must be derived from the types of income listed in section 856(c)(3) (75% Income Test). Interest on obligations secured by mortgages on real property or on interests in real property is included as qualifying income for purposes of the 75% Income Test.

.06 If a mortgage loan is secured by both real property and other property, then, for purposes of the 75% Income Test, § 1.856-5(c) provides rules for apportioning the interest on the loan between interest on an obligation that is secured by real property (or by an interest in real property) and interest on an obligation that is not so secured.

.07 The regulations define two terms that are to be used in determining apportionment—

(1) Section 1.856-5(c)(3) defines the "amount of the loan" as the highest principal amount of the loan outstanding during the taxable year.

(2) Section 1.856-5(c)(2) generally defines the "loan value of the real property" that secures a loan as the fair market value of the real property, determined as of the date on which a commitment became binding on the REIT either to make the loan or to purchase the loan, as the case may be. (This definition, which focuses on the value of the real property collateral securing a loan, is different from the § 1.856-3(a) "value" of a loan as discussed in section 2.04 of this revenue procedure, which focuses on what a loan can be sold for (whether the loan is secured by real property or by other property)).

.08 To effect apportionment under § 1.856-5(c), the loan value of the real property is compared to the amount of the loan.

(1) If the loan value of the real property is equal to or exceeds the amount of the loan, then all of the interest income from the loan is apportioned to the real property.

(2) If the amount of the loan exceeds the loan value of the real property, then—

(a) The interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction the numerator of which is the loan value of the real property and the denominator of which is the amount of the loan; and

(b) The interest income apportioned to the other property is the excess of the total interest income over the interest income apportioned to the real property.

.09 Section 1.1001-3(c)(1)(i) defines a “modification” of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of the debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001-3(e) governs which modifications of debt instruments are “significant.” Under § 1.1001-3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.

.10 Section 1.860G-2(b)(1) concerns modifications of mortgages held by real estate mortgage investment conduits (REMICs). Certain loan modifications are not significant for purposes of § 1.860G-2(b)(1) even if the modifications are significant under the rules in § 1.1001-3. In particular, under § 1.860G-2(b)(3)(i), if a change in the terms of an obligation is “occasioned by default or a reasonably foreseeable default,” the change is not a significant modification for purposes of § 1.860G-2(b)(1), regardless of the modification's status under § 1.1001-3.

.11 Section 857(b)(6) imposes a tax equal to 100 percent of the net income derived from “prohibited transactions.” Section 857(b)(6)(B)(iii) defines the term “prohibited transaction” as a sale or other disposition of property that is described in section 1221(a)(1) and that is not foreclosure property.

.12 Section 4.01 of Rev. Proc. 2011-16 provided a safe harbor to allow REITs to treat certain loan modifications occasioned by default or reasonably foreseeable default as not being a new commitment to make or purchase a loan for purposes of the 75% Income Test.

.13 Section 4.02 of Rev. Proc. 2011-16 also provided a safe harbor (the Asset Test Safe Harbor) for determining the extent to which a REIT may treat certain loans as real estate assets for purposes of the 75% Asset Test. Under this safe harbor, the Internal Revenue Service (Service) will not challenge a REIT’s treatment of a loan as being in part a “real estate asset” for purposes of the 75% Asset Test if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of—

(1) The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure); or

(2) The loan value of the real property securing the loan as determined under § 1.856-5(c) and section 4.01 of Rev. Proc. 2011-16 (see section 2.07(2) of this revenue procedure).

.14 The Service has become aware that when the value of the real property securing the loan (and, thus, generally the value of the loan as well) increases after the

REIT originates or acquires the loan, the Asset Test Safe Harbor may produce anomalous results.

(1) The Asset Test Safe Harbor addresses the numerator of the 75% Asset Test (the value of a REIT's real estate assets, cash and cash items, and Government securities, see section 2.01 and 2.02 of this revenue procedure). As is described in section 2.13 of this revenue procedure, under this safe harbor, the numerator is the *lesser* of the value of the loan (under § 1.856-3(a)) or the loan value of the real property securing the loan (under § 1.856-5(c) and section 4.01 of Rev. Proc. 2011-16). Although the "value of the loan" generally rises with increases in the value of the real property securing a distressed loan, the "loan value of the real property securing the loan" is fixed as of the date that the REIT commits to make or purchase the loan. The loan value of the real property securing the loan, therefore, does not vary with changes in the value of the loan's real property collateral. Thus, the numerator (the *lesser of* the value of the loan or the loan value of real property securing the loan) will generally not vary with increases in the value of the real property collateral.

(2) On the other hand, if there is an increase in the value of the real property collateral, that increase often results in a corresponding increase in the value of the loan and thus in the denominator of the 75% Asset Test (the value of the REIT's total assets, see section 2.01 of this revenue procedure).

(3) Thus, when the value of the real property collateral increases, the portion of a distressed mortgage loan that is treated as a qualifying asset for the 75% Asset Test is the generally constant numerator described above, divided by an increasing denominator. Under the formula in section 4.02 of Rev. Proc. 2011-16, therefore, the

portion of a mortgage loan that is treated as a qualifying asset for this purpose generally *decreases* as the value of the real property securing the loan *increases*.

(4) To prevent this anomaly, this revenue procedure modifies the Asset Test Safe Harbor in section 4.02 of Rev. Proc. 2011-16. This revenue procedure also modifies section 5 of Rev. Proc. 2011-16 by amending Examples 1 and 2 and adding a new Example 3 to illustrate the modified Asset Test Safe Harbor.

SECTION 3. SCOPE

.01 Section 4.01 of this revenue procedure applies to a modification of a mortgage loan which (or an interest in which) is held by a REIT if—

(1) The modification was occasioned by default; or

(2) The modification satisfies the following two conditions:

(a) Based on all the facts and circumstances, the REIT or servicer of the loan (the “pre-modified loan”) reasonably believes that there is a significant risk of default of the pre-modified loan upon maturity of the loan or at an earlier date. This reasonable belief must be based on a diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the issuer of the loan if the REIT or servicer neither knows nor has reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is *per se* not foreseeable. For example, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

(b) Based on all the facts and circumstances, the REIT or servicer reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modified loan.

.02 Section 4.02 of this revenue procedure applies to any corporation that has elected to be taxed as a REIT.

SECTION 4. APPLICATION

.01 *Modifications.* If a modification of a mortgage loan is described in section 3.01 of this revenue procedure—

(1) For purposes of ascertaining under § 1.856-5(c)(2) the loan value of the real property securing that loan, a REIT may treat the modification as not being a new commitment to make or purchase a loan; and

(2) The modification of the mortgage loan is not treated as a prohibited transaction under section 857(b)(6).

.02 *Asset test.* The Service will not challenge a REIT's treatment of a loan as being in part a "real estate asset" for purposes of section 856(c)(4) if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of—

(1) The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure); or

(2) The greater of—

(a) The current value of the real property securing the loan; or

(b) The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (see section 2.07(2) of this revenue procedure).

SECTION 5. EXAMPLES

.01 *Example 1*. In 2007, *X*, a REIT, made a $100 mortgage loan to *A*. *X*'s loan to *A* was secured by both real property and personal property. When *X*'s commitment to make the loan became binding on *X*, the real property had a fair market value of $115. At the end of the calendar quarter in which *X* made the loan, the value of the loan as determined under § 1.856-3(a) was $100. At all times through the end of 2010, under § 1.856-5(c)(3), the amount of the loan continued to be $100.

By the start of 2009, the fair market value of the real property securing the loan had fallen to $55 and the fair market value of the personal property was $5. The values remained at these levels throughout 2009 and 2010. Throughout 2009 and 2010, the value of the loan, as determined under § 1.856-3(a), was $60.

During 2009, *X* and *A* modified the terms of the mortgage loan. The modification of the loan is described in section 3.01 of this revenue procedure and is a significant modification under § 1.1001-3.

(1) *Income Test*. When *X* made the mortgage loan in 2007, the loan value of the real property for purposes of § 1.856-5(c) was its fair market value ($115) determined as of the date on which the commitment to make the loan became binding on *X*. This amount exceeded the amount of the loan for that year ($100). Accordingly, in the year that the loan was made, all of the interest from the loan was apportioned to the real property. *See* § 1.856-5(c)(1).

Between the time that the loan was made and the time of the modification, the loan value of the real property continued to be $115, notwithstanding changes in the fair market value of that real property. *See* § 1.856-5(c)(2). Similarly, the amount of the loan continued to be $100. Accordingly, the loan value of the real property ($115) continued to exceed the amount of the loan ($100), and all of the interest on the loan continued to be apportioned to the real property.

The fair market value of the real property that secured the mortgage loan had fallen to $55 by the time that *X* and *A* modified the loan in 2009. That modification, however, is described in section 3.01 of this revenue procedure, and *X* chose to treat the modification as not being a new commitment to make or purchase a loan.

Therefore, the loan value of the real property ($115) does not change. Because the loan value of the real property ($115) continued through the end of 2010 to exceed the amount of the loan ($100), all of the interest from the loan during that year is apportioned to real property.

(2) *Asset Test*. In 2007, at the end of the calendar quarter in which *X* made the mortgage loan, the current value of the real property securing the loan was $100, the value of the loan (as determined under § 1.856-3(a)) was $100, and the loan value of the real property securing the loan (as determined under § 1.856-5(c)(2)) was $115. For this calendar quarter, in determining the amount of the loan that is a real estate asset for purposes of the 75% Asset Test, *X* may use the safe harbor in section 4.02 of this revenue procedure. If *X* does so, the amount of the loan that is a real estate asset for purposes of the 75% Asset Test is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($100); or
- The greater of—
  - o The current value of the real property securing the loan ($100); or
  - o The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) ($115).

Accordingly, *X* may treat $100 of the loan as a qualifying asset.

At the end of the calendar quarter immediately preceding the quarter in 2009 in which *X* modified the mortgage loan, the current value of the real property securing the loan was $55, the value of the loan (as determined under § 1.856-3(a)) was $60, and the loan value of the real property securing the loan (as determined under § 1.856-5(c)(2)) was $115. As described earlier in this section 5.01, beginning with the calendar quarter in which the loan was modified, *X* may use the safe harbor in section 4.01 of this revenue procedure to treat the modification as not being a new commitment to make or purchase the loan. In addition, in determining the amount of the loan that is a real estate asset for purposes of the 75% Asset Test, *X* may use the safe harbor in section 4.02 of this revenue procedure. If *X* does so, the amount of the loan that is a real estate asset for purposes of the 75% Asset Test is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($60); or
- The greater of—
  - o The current value of the real property securing the loan ($55); or
  - o The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is applicable) ($115).

Accordingly, *X* may treat $60 of the loan as a qualifying asset.

.02 *Example 2*. The facts include all of the facts in Example 1. Additionally, during the first quarter of 2010, *Y*, a REIT, committed to purchase, and purchased, the mortgage loan from *X* for $60.

(1) *Income Test*. Under § 1.856-5(c)(2), the loan value of the real property securing the loan is the fair market value of the real property determined as of the date on which *Y*'s commitment to purchase the loan became binding on *Y* ($55). This value is compared to the amount of the loan for the year ($100). Because the amount of the loan exceeds the loan value of the real property, the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction the numerator of which is the loan value of the real property ($55) and the denominator of which is the amount of the loan ($100). Therefore, 55 percent of the interest income from *Y*'s loan is apportioned to the real property securing the loan. Interest income apportioned to the other property is the excess of the total interest income over the interest income apportioned to the real property. *See* § 1.856-5(c)(2).

(2) *Asset Test*. At the end of every calendar quarter during 2010, the current value of the real property securing the loan was $55, the value of the loan (as determined under § 1.856-3(a)) was $60, and the loan value of the real property securing the loan (as determined under § 1.856-5(c)(2)) was $55. For every calendar quarter during 2010, in determining the amount of the loan that is a real estate asset for purposes of the 75% Asset Test, *Y* may use the safe harbor in section 4.02 of this revenue procedure. If *Y* does so, the amount of the loan that is a real estate asset for purposes of 75% Asset Test is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($60); or
- The greater of—
  - o The current value of the real property securing the loan ($55); or
  - o The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) ($55).

Accordingly, *X* may treat $55 of the loan as a qualifying asset.

.03 *Example 3.* On January 1, 2011, *Z,* a REIT, purchased for $60 a distressed mortgage loan with a principal amount due of $100. During the taxable year 2011, the amount of the loan under § 1.856-5(c)(2) was $100. The value of the real property securing the loan on the date *Z* committed to purchase the loan was $55 and the value of the personal property securing the loan was $5. At the end of the first calendar quarter in 2011, the current value of the real property securing the loan was $55, and the value of the loan (as determined under § 1.856-3(a)) was $60.

Asset Test. Under section 4.02 of this revenue procedure, *Z* may treat $55 of the loan as a "real estate asset" for purposes of the 75% Asset Test. This amount is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($60); or
- The greater of—
  - o The current value of the real property securing the loan ($55); or

- o The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) ($55).

At the end of the second calendar quarter of 2011, the current value of the real property securing the loan had increased to $65, and the value of the loan (as determined under § 1.856-3(a)) had increased to $70. Accordingly, at the end of the second quarter of 2011, under section 4.02 of this revenue procedure, *Z* may treat $65 of the loan as a “real estate asset” for purposes of the 75% Asset Test. This amount is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($70); or
- The greater of—
  - o The current value of the real property securing the loan ($65); or
  - o The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) ($55).

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for all calendar quarters and all taxable years.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2011-16 is modified and superseded.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Jonathan D. Silver of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Mr. Silver at (202) 317-4413 (not a toll-free call).

General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals

Department of the Treasury
February 2015

MODIFY LIKE-KIND EXCHANGE RULES FOR REAL PROPERTY AND COLLECTIBLES

Current Law

When capital assets are sold or exchanged, capital gain or loss is generally recognized. Under section 1031, however, no gain or loss is recognized when business or investment property is exchanged for "like-kind" business or investment property. As a result, the tax on capital gain is deferred until a later realization event, provided that certain requirements are met. The "like-kind" standard under section 1031, which focuses on the legal character of the property, allows for deferral of tax on the exchange of improved and unimproved real estate. Certain properties, including stocks, bonds, notes or other securities or evidences of indebtedness are excluded from nonrecognition treatment under section 1031. Exchanges of art and collectibles for investment are eligible for deferral of gain under section 1031.

Reasons for Change

There is little justification for allowing deferral of the capital gain on the exchange of real property or art and collectibles. Historically, section 1031 deferral has been justified on the basis that valuing exchanged property is difficult. However, for the exchange of one property for another of equal value to occur, taxpayers must be able to value the properties. In addition, many, if not most, exchanges affected by this proposal are facilitated by qualified intermediaries who help satisfy the exchange requirement by selling the exchanged property and acquiring the replacement property. These complex three-party exchanges were not contemplated when the provision was enacted. They highlight the fact that valuation of exchanged property is not the hurdle it was when the provision was originally enacted. Further, the ability to exchange unimproved real estate for improved real estate encourages "permanent deferral" by allowing taxpayers to continue the cycle of tax deferred exchanges.

Proposal

The proposal would limit the amount of capital gain deferred under section 1031 from the exchange of real property to $1 million (indexed for inflation) per taxpayer per taxable year. The proposal limits the amount of real estate gain that qualifies for deferral while preserving the ability of small businesses to generally continue current practices and maintain their investment in capital. In addition, art and collectibles would no longer be eligible for like-kind exchanges. Treasury would be granted regulatory authority necessary to implement the provision, including rules for aggregating multiple properties exchanged by related parties.

The provision would be effective for like-kind exchanges completed after December 31, 2015.

REPEAL PREFERENTIAL DIVIDEND RULE FOR PUBLICLY TRADED AND PUBLICLY OFFERED REAL ESTATE INVESTMENT TRUSTS (REITS)

Current Law

REITs are allowed a deduction for dividends paid to their shareholders. In order to qualify for the deduction, a dividend must not be a "preferential dividend." For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference. Previously, a similar rule had applied to all regulated investment companies (RICs). Section 307 of the Regulated Investment Company Modernization Act of 2010 repealed application of that rule for publicly offered RICs.

Reasons for Change

The original purpose of the preferential dividend rule in 1936 was to prevent tax avoidance by closely held personal holding companies. The inflexibility of the rule can produce harsh results for inadvertent deviations in the timing or amount of distributions to some shareholders. Because an attempt to compensate for a preference in one distribution produces a preference in a second offsetting distribution, it is almost impossible to undo the impact of a prior error. As applied to publicly traded REITs and publicly offered REITs, the rule has ceased to serve a necessary function either in preventing tax avoidance or in ensuring fairness among shareholders. Today, for these shareholders, corporate and securities laws bar preferences and ensure fair treatment.

Proposal

The proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if:

1. As of the record date of the distribution, the REIT was publicly traded; or

2. As of the record date of the distribution:
    a. The REIT was required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Act of 1934;
    b. Not more than one-third of the voting power of the REIT was held by a single person (including any voting power that would be attributed to that person under the rules of section 318); and
    c. Either the stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10-year period.

The Secretary would also be given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule where it continues to apply and, where appropriate, to require consistent treatment of shareholders.

The proposal would apply to distributions that are made (without regard to section 858) in taxable years beginning after the date of enactment.

For Immediate Release
March 11, 2015

Contact: Aaron Fobes, Julia Lawless (202) 224-4515

Hatch, Wyden Launch New Effort to Seek Input on Bipartisan Tax Reform

Stakeholders and the Public Asked to Submit Ideas to Working Groups

WASHINGTON – Finance Committee Chairman Orrin Hatch (R-Utah) and Ranking Member Ron Wyden (D-Ore.) today announced a bipartisan effort to begin soliciting ideas from interested members of the public and stakeholders on how best to overhaul the nation's broken tax code to make it simpler, fairer, and more efficient. The goal of this effort is to provide additional input, data, and information to the Committee's bipartisan tax working groups, which are currently analyzing existing tax law and examining policy trade-offs and available reform options within each group's designated area.

"By opening up our bipartisan working groups to public input, we hope to gain a greater understanding of how tax policy affects individuals, businesses, and civic groups across our nation," **Hatch and Wyden said**. "In doing so, we will also equip our working groups with valuable input, and we hope these suggestions will help guide the groups through the arduous task of putting forth substantive ideas to reform the tax code in each of their areas."

Individuals, businesses, organizations, and advocacy groups interested in submitting comments should send an email to the below bipartisan group or groups that relates to their area of interest. Please send submissions to each group of jurisdiction if an interest area covers more than one group.

Individual Income Tax - Individual@finance.senate.gov

Business Income Tax - Business@finance.senate.gov

Savings & Investment - Savings@finance.senate.gov

International Tax - International@finance.senate.gov

Community Development & Infrastructure - CommunityDevelopment@finance.senate.gov

Additional Submission Requirements:

- All submissions must be submitted as a pdf attachment. The attachment should be saved using the name of the organization/individual submitting the recommendations.
- Parties should list the name of the tax working group they wish to contact in the subject line of the email.
- Please include contact name, organization (if the submission is being submitted on behalf of a group), phone number, and email address, in the body of the email.
- Submissions will be accepted through April 15, 2015, and made public at a later date.
- If the above directions are not followed, the Committee reserves the right to not include the submission.
- If technical problems are incurred, parties can contact the Committee at 202-224-4515.

Each of the five bipartisan working groups is currently working to produce findings on current tax policy and legislative recommendations within its area, with the goal of having recommendations from each of the five working groups completed by the end of May. Submissions from stakeholders will be reviewed by the working groups and ideas can be incorporated into the each working group's final recommendations. The five working group recommendations will be delivered to Chairman Hatch and Ranking Member Wyden, and will be considered in developing bipartisan tax reform legislation.

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03/17 Five Years Later: Failed Oversight & Security Safeguards Put Americans' Personal Information at Risk [Chair]

03/17 Hatch Statement at Finance Hearing on Building a Competitive U.S. International Tax System [Chair]

03/16 Five Years Later: Obamacare Hits Americans with Higher Premiums for Healthcare Coverage [Chair]

03/13 Hatch Calls for Bipartisan Fix to Restore Social Security Disability Insurance Fund [Chair]

03/12 Hatch Statement at Finance Hearing on Tax Schemes and Scams [Chair]

II

114TH CONGRESS
1ST SESSION

H. R. 636

IN THE SENATE OF THE UNITED STATES

FEBRUARY 23, 2015
Received

AN ACT

To amend the Internal Revenue Code of 1986 to permanently extend increased expensing limitations, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the ''America's Small Business Tax Relief Act of 2015''.

SEC. 2. EXPENSING CERTAIN DEPRECIABLE BUSINESS ASSETS FOR SMALL BUSINESS.

(a) IN GENERAL.—

(1) DOLLAR LIMITATION.—Section 179(b)(1) of the Internal Revenue Code of 1986 is amended by striking ''shall not exceed—'' and all that follows and inserting ''shall not exceed $500,000.''.

(2) REDUCTION IN LIMITATION.—Section 179(b)(2) of such Code is amended by striking ''exceeds—'' and all that follows and inserting ''exceeds $2,000,000.''.

(b) COMPUTER SOFTWARE.—Section 179(d)(1)(A)(ii) of such Code is amended by striking '', to which section 167 applies, and which is placed in service in a taxable year beginning after 2002 and before 2015'' and inserting ''and to which section 167 applies''.

(c) ELECTION.—Section 179(c)(2) of such Code is amended—

(1) by striking ''may not be revoked'' and all that follows through ''and before 2015''; and

(2) by striking ''IRREVOCABLE'' in the heading thereof.

(d) AIR CONDITIONING AND HEATING UNITS.—Section 179(d)(1) of such Code is amended by striking ‘‘and shall not include air conditioning or heating units’’.

(e) QUALIFIED REAL PROPERTY.—Section 179(f) of such Code is amended—

(1) by striking ‘‘beginning after 2009 and before 2015’’ in paragraph (1); and

(2) by striking paragraphs (3) and (4).

(f) INFLATION ADJUSTMENT.—Section 179(b) of such Code is amended by adding at the end the following new paragraph:

‘‘(6) INFLATION ADJUSTMENT.—

‘‘(A) IN GENERAL.—In the case of any taxable year beginning after 2015, the dollar amounts in paragraphs (1) and (2) shall each be increased by an amount equal to—

‘‘(i) such dollar amount, multiplied by

‘‘(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting ‘calendar year 2014’ for ‘calendar year 1992’ in subparagraph (B) thereof.

"(B) ROUNDING.—The amount of any increase under subparagraph (A) shall be rounded to the nearest multiple of $10,000.".

(g) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2014.

SEC. 3. REDUCED RECOGNITION PERIOD FOR BUILT-IN GAINS OF S CORPORATIONS MADE PERMANENT.

(a) IN GENERAL.—Paragraph (7) of section 1374(d) of the Internal Revenue Code of 1986 is amended to read as follows:

"(7) RECOGNITION PERIOD.—

"(A) IN GENERAL.—The term 'recognition period' means the 5-year period beginning with the first day of the first taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase '5-year'.

"(B) INSTALLMENT SALES.—If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.''.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2014.

SEC. 4. PERMANENT RULE REGARDING BASIS ADJUSTMENT TO STOCK OF S CORPORATIONS MAKING CHARITABLE CONTRIBUTIONS OF PROPERTY.

(a) IN GENERAL.—Section 1367(a)(2) of the Internal Revenue Code of 1986 is amended by striking the last sentence.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to contributions made in taxable years beginning after December 31, 2014.

SEC. 5. BUDGETARY EFFECTS.

The budgetary effects of this Act shall not be entered on either PAYGO scorecard maintained pursuant to section 4(d) of the Statutory Pay-As-You-Go Act of 2010.

Passed the House of Representatives February 13, 2015.

Attest: KAREN L. HAAS,

Clerk.

DESCRIPTION OF H.R. 629, A BILL TO MAKE PERMANENT THE REDUCED RECOGNITION PERIOD FOR BUILT-IN GAINS OF S CORPORATIONS

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
on February 4, 2015

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

February 3, 2015
JCX-14-15

CONTENTS

INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of H.R. 629, a bill to make permanent the reduced recognition period for built-in gains of S corporations on February 4, 2015. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 629, A Bill to Make Permanent the Reduced Recognition Period for Built-in Gains of S Corporations* (JCX-14-15), February 3, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

A. Reduced Recognition Period for Built-in Gains of S Corporations Made Permanent (sec. 1374 of the Code)

Present Law

In general

S corporations

A small business corporation[2] may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.[3]

A corporate level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on an S corporation's net recognized built-in gain[4] that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, (*i.e.*, the 10-year period beginning with the first day of the first taxable year for which the S election is in effect).[5] If the taxable income of the S corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no built-in gain tax is imposed on the excess of such built-in gain over taxable income for that year. However, the untaxed excess of net recognized built-in gain over taxable income for that year is treated as recognized built-in gain in the succeeding taxable year.[6] Treasury regulations provide that if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method [7] during or after the recognition period, that income is subject to the built-in gain tax.[8]

The built-in gain tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or

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[2] This term is defined in section 1361(b).

[3] Sec. 1366.

[4] Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

[5] Sec. 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation. Treas. Reg. sec. 1.1374-1(d).

[6] Sec. 1374(d)(2).

[7] Sec. 453.

[8] Treas. Reg. sec. 1.1374-4(h).

other property) in the hands of the C corporation.[9] In the case of such a transaction, the recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.[10]

The amount of the built-in gains tax is treated as a loss by each of the S corporation shareholders in computing its own income tax.[11]

For any taxable year beginning in 2009 and 2010, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year.[12] Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the seventh taxable year that the S corporation election was in effect preceded the taxable year beginning in 2009 or 2010.

For any taxable year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the fifth year in the corporation's recognition period preceded such taxable year.[13] Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the S corporation election was in effect for five years preceding the taxable year beginning in 2011.

For taxable years beginning in 2012, 2013, and 2014, the term "recognition period" in section 1374, for purposes of determining the net recognized built-in gain, is applied by substituting a five-year period[14] for the otherwise applicable 10-year period. Thus, for such taxable years, the recognition period is the five-year period beginning with the first day of the first taxable year for which the corporation was an S corporation (or beginning with the date of acquisition of assets if the rules applicable to assets acquired from a C corporation apply). If an S corporation with assets subject to section 1374 disposes of such assets in a taxable year beginning in 2012, 2013, or 2014 and the disposition occurs more than five years after the first day of the relevant recognition period, gain or loss on the disposition will not be taken into account in determining the net recognized built-in gain.

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[9] Sec. 1374(d)(8).

[10] Sec. 1374(d)(8)(B).

[11] Sec. 1366(f)(2). Shareholders continue to take into account all items of gain and loss under section 1366.

[12] Sec. 1374(d)(7)(B).

[13] Sec. 1374(d)(7)(C).

[14] The five-year period refers to five calendar years from the first day of the first taxable year for which the corporation was an S corporation.

If an S corporation subject to section 1374 sells a built-in gain asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received will be governed by the provisions of section 1374(d)(7) applicable to the taxable year in which the sale was made.

Application to real estate investment trusts and regulated investment corporations

Under Treasury regulations, a regulated investment company ("RIC") or a real estate investment trust ("REIT") that was formerly a C corporation not taxed as a REIT or RIC (or that acquired assets from such a C corporation) generally is subject to the built-in gain tax rules as if the RIC or REIT were an S corporation, unless the relevant C corporation elects "deemed sale" treatment, requiring recognition of all C corporation built-in gain and loss at the time of the conversion or asset acquisition.[15] Deemed sale treatment is not permitted if its application would result in the recognition of a net loss.[16] For this purpose, net loss is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.[17]

Description of Proposal

The proposal makes permanent the five-year recognition period for built-in gains of S corporations. Under current Treasury regulations, this five-year recognition period also would apply to real estate investment trusts and regulated investment companies that do not elect "deemed sale" treatment.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

[15] Treas. Reg. secs. 1.337(d)-7(a) and 1.337(d)-7(b).

[16] Treas. Reg. sec. 1.337(d)-7(c)(1).

[17] Treas. Reg. sec. 1.337(d)-7(c)(1).

B. Estimated Revenue Effects

Fiscal Years [Millions of Dollars]												
2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2015-20**	**2015-25**
-70	-218	-283	-222	-147	-103	-84	-81	-86	-92	-99	-1,043	-1,485

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9 January 2015

SENT VIA E-MAIL TO TAXTREATIES@OECD.ORG

Marlies de Ruiter
Head
Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2, rue André Pascal
75775 Paris Cedex 16
France

Re: Comments on the OECD Discussion Draft on Follow Up Work on BEPS Action 6

Dear Ms. De Ruiter:

The National Association of Real Estate Investment Trusts (NAREIT[1]) appreciates the opportunity to provide comments on the OECD's 21 November 2014 Discussion Draft on Follow Up Work on BEPS Action 6 Preventing Treaty Abuse (Discussion Draft). The Discussion Draft invites comments on a variety of issues with respect to changes to the OECD Model Tax Convention and related Commentary that have been proposed under Action 6 of the BEPS Action Plan with the objective of preventing the granting of treaty benefits in inappropriate circumstances.

The Discussion Draft identifies issues to be addressed with respect to the proposed limitation on benefits (LOB) provision and with respect to the proposed principal purpose test (PPT) provision. The Discussion Draft highlights in particular issues related to the treaty entitlement of collective investment vehicles (CIVs) and certain other investment entities.

EXECUTIVE SUMMARY

This submission focuses on the treaty entitlement issues with respect to U.S. REITs. Our comments build on work already done by the OECD with respect to REITs as reflected in its 2007 Report *Tax Treaty Issues Related to REITs*. As discussed in more detail below, U.S. REITs are different from both CIVs and non-CIV funds in ways that are directly relevant to treaty qualification.

[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.

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

Consistent with the OECD's prior work, the eligibility of U.S. REITs for treaty benefits should be determined under the rules applicable to companies. Given that resident status is a threshold question for treaty qualification, we urge the OECD to explicitly reference its prior work on REITs and their residence status in the current work on Action 6. Moreover, in light of the special circumstances of REITs as recognized by the OECD in its prior work, we urge the OECD to provide greater clarity regarding the application of both the proposed LOB provision and the proposed PPT provision to U.S. REITs.

DISCUSSION

I. Differences between U.S. REITs and CIVs and Non-CIV Funds

The first two issues identified in the Discussion Draft are the application of the LOB provision, and treaty entitlement more generally, in the case of CIVs and non-CIV funds. With respect to CIVs, the Discussion Draft references to the work done in connection with the 2010 OECD Report *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*.

The Discussion Draft specifically refers to REITs, stating that "REITs are covered by the 2010 Report on CIVs to the extent that they are widely-held and regulated." In this regard, the CIV Report defines the term "CIV" to mean "funds that are widely-held, hold a diversified portfolio of securities and are subject to investor protection regulation in the country in which they are established."

U.S. REITs do not fall within this definition of a CIV. Unlike U.S. regulated investment companies (RICs), U.S. REITs are not generally within the scope of the Investment Company Act of 1940, which regulates the organization and disclosure of financial information of entities, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. Thus, U.S. REITs are not subject to the type of investor protection regime contemplated in the OECD definition of a CIV.

Many U.S. REITs are registered with the U.S. Securities and Exchange Commission (SEC) and are publicly traded on a stock exchange. Other U.S. REITS that are not listed on a stock exchange are widely-held and therefore also are registered with the SEC. These U.S. REITs are subject to provisions in the Securities Exchange Acts of 1933 and 1934 that contain rigorous disclosure obligations. However, this disclosure regime applies to any public-traded U.S. corporation. We do not believe that rules that generally are applicable to listed companies are what motivated the investor protection regulation requirement in the OECD definition of a CIV.

Moreover, the assets of U.S. REITs generally would not be characterized as a "diversified portfolio of securities." U.S. REITs own, operate, and finance income-producing real estate, such as apartments, shopping centers, office buildings, health care facilities, hotels, and warehouses. Under U.S. tax law requirements, i) at least 75% of the value of a U.S. REIT's total assets must be represented by real estate assets (including mortgages), cash and cash items, and government securities; and, ii) not more than 25% of its total assets may be represented by securities that are not qualifying assets for purposes of i). In addition, U.S. tax law requires that at least 75% of a U.S. REIT's gross income must be in the form of real estate rents, interest on real estate mortgages, gains from real estate sales, and other real estate related income. The types of assets required to be held by U.S. REITs is in contrast to the definition of "securities" contained in the Investment Company Act of 1940.[2] Importantly, Section 3(c)(5)C) of the 1940 Act specifically excludes from the 1940 Act any person who is primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate". Given the asset and income tests applicable to U.S. REITs, virtually all U.S. REITs fall outside of 1940 Act governance.

Consequently, while U.S. REITs share some characteristics in common with CIVs, they cannot be considered CIVs for purposes of the Discussion Draft because they do not meet the regulatory regime or asset ownership requirements that are central to the OECD definition of a CIV.

The Discussion Draft briefly refers to REITs that do not qualify as CIVs as potentially facing treaty issues similar to issues faced by alternative funds and private equity funds. In this regard, it is important to recognize that U.S REITs are not "funds." U.S. REITs are not passive investment holding entities. Rather, U.S. REITs are active businesses that engage in a full range of corporate activities. U.S. "equity" REITs acquire, develop and hold properties in order to generate rental income, and they primarily operate such properties (as opposed to developing and selling properties similar to a merchant builder). U.S. "mortgage" REITs actively fund both residential and commercial real estate assets.

The U.S. Internal Revenue Service has affirmed that a U.S. REIT functions as an operating company, as distinguished from a passive manager similar to an investment fund, because a U.S. REIT "is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property."[3] Moreover, as discussed further below, U.S. REITs must be taxable as U.S. corporations.

U.S. REITs also are characterized as operating companies rather than investment vehicles in a variety of other contexts in the United States:

- The North American Industry Classification System (NAICS) lists U.S. REITs in the "Lessors of Real Estate" category, which is where active real estate operators are classified, as opposed to the "Other Financial Vehicles" category, where passive investment entities are classified.

[2] The Investment Company Act of 1940 defines "security" as: "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ''security'', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." (15 U.S.C. § 80-2(a)(36).)
[3] Rev. Rul. 2001-29, 2001-26 I.R.B. 1348.

- The U.S. Commodity Futures Trading Commission (CFTC), in a 2012 Interpretive Letter issued to NAREIT, concluded that U.S. REITs are not commodity pools because they are operating companies rather than pooled investment vehicles.
- Standard & Poor's (S&P) classifies U.S. REITs as operating companies in all of its broad equity indices. As of 31 December 2014, the S&P 100 includes one U.S. REIT, the S&P 500 includes 21 U.S. REITs, the S&P 400 includes 31 U.S. REITs and the S&P 600 includes 34 U.S. REITs.

Finally, in this regard, we note that the Discussion Draft states that treaty qualification issues affecting non-CIV funds can arise because their investor base typically is not restricted to a single country and because they may not meet the active business requirement. Contrary to the suggestion in the Discussion Draft, U.S. REITs do not share these issues. The vast majority of investors in U.S. REITs are U.S. persons and, as discussed above, U.S. REITs conduct active businesses in the United States.

Although U.S. REITs do not constitute CIVs or non-CIV funds, as discussed further below, clarification regarding the treaty status of REITs would be valuable in light of the proposed changes to the OECD Model Tax Convention and related Commentary.

II. Treatment of U.S. REITs as Residents for Treaty Purposes

The starting point in applying both the proposed LOB provision and the proposed PPT provision is a determination of resident status. The Discussion Draft underscores the connection between residence and qualification under the proposed provisions in its discussion of issues with respect to CIVs and non-CIV funds. The status of REITs as residents for treaty purposes was considered and addressed in the OECD's 2007 REIT Report. Given its relevance and importance, the OECD should explicitly incorporate this prior work into the current work on treaty qualification under Action 6.

The primary focus of the 2007 REIT Report was the tax treaty treatment of REIT distributions to foreign shareholders. The Report included proposed treaty provisions regarding the withholding tax treatment of such distributions that could be included by countries in their bilateral treaties. These provisions subsequently were incorporated in the Commentary to the OECD Model Tax Convention with the 2008 update.

Consideration of the question of the tax treaty treatment of distributions by REITs to foreign shareholders first requires a determination of the tax treaty entitlement of the REIT itself. As the 2007 REIT Report noted, this is because Article 10 of the OECD Model applies to dividends paid by a company that is a "resident" of a treaty country. Thus, the resident status of a REIT is relevant to the application of tax treaties, both with respect to the income earned and to distributions made by a REIT

The 2007 REIT Report concluded that REITs generally should be considered to be "residents" for treaty purposes:

> Since the income of a REIT is typically distributed, the REIT is not, in a purely domestic context, taxed on that distributed income. As already mentioned, the tax mechanisms that ensure that result vary from country to country and can include, for example, rules that allow the deduction of REIT dividends or distributions, the tax exemption of a REIT that meets certain conditions, the tax exemption of all the REIT's income, the tax exemption of only the part of the REIT's income that is distributed within a specified period of time or rules that allocate the income to the investors rather than to the REIT itself. It seems, however, that in most cases, the REIT would meet the condition of being liable to tax for purposes of the treaty definition of "resident of a Contracting State", subject to the particular problems arising from the application of tax treaties to trusts. There are a few countries, however, where this may not be the case and this is a question that would need to be clarified on a country-by-country basis during treaty negotiations.

Under this analysis, U.S. REITs are residents of the United States. Under U.S. tax law, a U.S. REIT is taxable as a U.S. corporation (and, in fact, must be taxable as a U.S. corporation in order to qualify as a U.S. REIT). The taxable income of a U.S. REIT is computed in a manner similar to the manner in which taxable income is computed for non-REIT corporations. A U.S. REIT is required to distribute at least 90% of its taxable income on a current basis in order to qualify as a REIT and is entitled to a "dividends paid deduction" to the extent that it distributes its taxable income and any realized capital gains. To the extent that a U.S. REIT does not distribute its net capital gain, it still qualifies as a REIT, and it pays corporate tax on such net capital gain.

It should be noted that, although a U.S. REIT does not pay income tax at the entity level to the extent that it distributes its annual taxable income, the mandatory distribution rules mean that U.S. REITs pay significant amounts of taxable dividends relative to other corporate entities. Further, shareholders pay tax on the REIT dividends they receive at the ordinary income tax rate rather than the lower rates generally applicable to corporate dividends. In 2013, SEC-registered U.S. REITs distributed approximately $34 billion. Thus, the amount of U.S. and state tax collected on a current basis with respect to income distributed by U.S. REITs is high.

The OECD's analysis and conclusion regarding the qualification of REITs as residents for treaty purposes formed the basis for the provisions on the withholding tax treatment of distributions by REITs that were set forth in the 2007 REIT Report and incorporated in the Commentary to the OECD Model Tax Convention. This same matter of the qualification of REITs as residents for treaty purposes is a threshold question in applying both the proposed LOB provision and the proposed PPT provision. Application of these proposed measures to REITs necessarily requires a clear understanding of the threshold question of resident status. The OECD should provide the needed clarity by explicitly referencing its prior work on the resident status of REITs in the Commentary with respect to the proposed provisions.

III. Treatment of U.S. REITs under LOB Provisions

The September 2014 Report under Action 6 *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* describes the proposed LOB provision and its various tests as "based on objective criteria that provide more certainty than the PPT rule." However, that certainty exists for a taxpayer only if it is clear that the tests under the LOB provision are available to be applied to the taxpayer. We believe that many U.S. REITs clearly would satisfy the requirements of one or more of the entity-based tests in the LOB provision if it is made clear that such tests are available to be applied to U.S. REITs.

With respect to U.S. REITs that are registered with the SEC and are publicly-traded on a stock exchange (U.S. Listed REITs), the primary test in the proposed LOB provision is the test under paragraph 2(c) (Exchange Traded Test).

Under the proposed Exchange Traded Test, a resident of a Contracting State would be entitled to benefits under the relevant treaty if such resident is a company or other entity and two requirements are met. First, the principal class of its shares (and any disproportionate class) must be regularly traded on one or more recognized stock exchanges. Second, either: i) its principal class of shares must be primarily traded on one or more recognized stock exchanges located in the Contracting State of which it is a resident; or, ii) its primary place of management and control must be in the Contracting State of which it is a resident.

U.S. Listed REITs typically are listed on the New York Stock Exchange, the NYSE MKT, or the NASDAQ. The shares of U.S. Listed REITs regularly are traded on such market, with active turnover and significant liquidity. In addition, the shares of U.S. Listed REITs primarily are traded on the U.S. market where listed. Moreover, U.S. Listed REITs have their primary place of management and control in the United States, where the day-to-day responsibility for the management of the REIT is exercised.

While the entitlement to treaty benefits under this test would be based on the particular facts and circumstances, it would be helpful for the Commentary to specifically state that this test is available for application to a U.S. REIT provided that it meets the specified conditions with respect to exchange trading and management.

With respect to U.S. REITs that are widely-held but not listed on a stock exchange (U.S. Public Non-listed REITs), the primary test in the proposed LOB provision would be the test under paragraph 2(e) (Ownership and Base Erosion Test).

To satisfy the proposed Ownership and Base Erosion Test, a resident of the Contracting State must satisfy both an ownership requirement and a base erosion requirement.

The ownership requirement would be satisfied if, on at least half the days of the taxable period, persons who are residents of that State and who are entitled to the benefits of the relevant treaty (generally as individuals, Contracting States, exchange traded companies or other entities, or non-profit entities or pension funds) own, directly or indirectly, shares representing at least 50% of the aggregate voting power and value (and at least 50% of any disproportionate class of shares) of the U.S. Public Non-listed REIT. This rule may be subject to a further requirement that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State.

In addition, to satisfy the base erosion requirement, less than 50% of the gross income, as determined in its Contracting State of residence of the U.S. Public Non-listed REIT, for the taxable period could be paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of the relevant treaty (also as individuals, Contracting States, exchange traded companies or other entities, or non-profit entities or pension funds) in the form of payments that are deductible for purposes of the taxes covered by the relevant treaty in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property).

U.S. Public Non-listed REITs typically would satisfy both prongs of this test. They are predominantly owned by U.S. persons, including U.S. mutual funds, individual investors and pension funds. Moreover, the income of U.S. REITs is distributed to their owners on a current basis, and the owners are subject to tax on such income. Because such distributions are deductible by U.S. REITs, they could be considered to be payments that are taken into account under the base erosion requirement. As noted above, the owners of U.S. REITs are predominantly U.S. persons who would themselves qualify for treaty benefits under one of the specified categories, and the distributions to such persons would not run afoul of the base erosion requirement.

As noted above, while the entitlement to treaty benefits under this test would be based on the particular facts and circumstances, it would be helpful for the Commentary to specifically state that this test is available for application to a U.S. REIT that meets the specified conditions with respect to ownership and base erosion.

IV. Treatment of U.S. REITs under PPT Provision

The September 2014 Report on Action 6 acknowledges that the proposed PPT provision involves relatively less certainty and "requires a case-by-case analysis based on what can reasonably be considered to be one of the principal purposes of transactions or arrangements." The subjectivity of the proposed PPT provision has been subject to significant criticism as involving a level of uncertainty that is unacceptable with respect to a matter as fundamental as the qualification of a company for treaty benefits. The concern about uncertainty is particularly acute in the case of U.S. REITs which, unlike other non-REIT corporations, not only must distribute the majority of their earnings to their investors on a current basis, but also cannot make effective use of foreign tax credits in the United States (and therefore cannot "absorb" any additional foreign tax liability in the same manner as non-REIT U.S. corporations). The risk of having an unexpected tax liability arise after the full distribution of current earnings because of a challenge with respect to potential withholding tax liability under a PPT provision would have a significant chilling effect on cross-border investments. The distribution requirement applicable to U.S. REITs means that a U.S. REIT must have a high degree of certainty regarding the tax treatment of its structure when deciding to make a cross-border investment. The uncertainty inherent in the proposed PPT provision would be a significant negative factor to U.S. REITs when deciding whether to make a cross-border investment. This uncertainty could impede the free flow of capital.

The fact that U.S. REITs are accorded tax treatment that is different than that of other corporations should not be a factor in applying the proposed PPT provision. Guidance should be included in the Commentary to make clear that the fact that a U.S. REIT is subject to a special tax regime (a deduction for dividends paid) should not be considered a factor that weighs in favor of denying benefits under any application of the proposed PPT provision.

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We appreciate the OECD's focus on ensuring that the changes to the OECD Model Tax Convention and related Commentary that have been proposed under Action 6 in order to prevent the granting of treaty benefits in inappropriate circumstances do not operate to inappropriately deny treaty benefits to investment vehicles that have become such an important part of the global economy. NAREIT welcomes this opportunity to provide comments on the need for specific clarification regarding the treaty qualification of U.S. REITS under the proposed provisions. With the focus on clarifying the treatment of other investment vehicles such as CIVs and non-CIV funds, the need is all the greater for these clarifications regarding the entitlement of U.S. REITs to treaty benefits under the proposed LOB provision or the proposed PPT provision.

We would be happy to discuss the matters addressed in this letter or to respond to questions or to provide additional information. I can be reached at (202) 739-9408 or tedwards@nareit.com.

Respectfully submitted,

Tony M. Edwards
Executive Vice President and General Counsel

Memo

TO	*Jacques Sasseville, OECD Paris*
FROM	*EPRA (Fraser Hughes / Jean Edouard Carbonnelle / Ronald Wijs, GiuseppeAndrea Giannantonio)*
CC.	*Philip Charls, CEO EPRA*
DATE	*Tony Edwards, NAREIT*
	March 05, 2015
REFERENCE	*18100727*
RE	**BEPS Action 6 – REITs and Treaty Abuse**

Introduction

1 During our meeting of Friday January 30 last, we discussed the above subject and the position of REITs. Reference is also made to our previous submissions, a copy of which is attached for your convenience.

2 We discussed the absence of a reference to the position of REITs in the OECD's publications on Action 6 and the OECD 2007 REITs report[1]. We have observed with great interest the discussions that you had with NAREIT and we welcome the fact that the OECD recognises that more attention should be given to the specific position of REITs (not being CIVs or non-CIVs) as residents of tax treaties.

3 We promised you to provide you with a brief and 'to-the-point' outline of our views on the position of REITs under the proposed LOB rule and the PPT. Below, we will outline why we think REITs are *inherently* not in the game of "tax treaty shopping" and we make a brief proposal for including an example to the proposed amendment to the Commentary to the Model Convention, as well as a proposal for a simplification of the LOB rule.

Why REITS are inherently not Abusive

4 Part of the OECD definition of REITs is that these are widely held (often on the basis of a stock listing). In the vast majority of cases REITs are 'self-managed' (unlike CIVs) and have adequate and transparent governance systems in place. REITs benefit from a 'flow through' regime: the point of taxation is moved from the company to the shareholders (on the basis of an obligation to distribute the annual profit or earnings). All REIT regimes in OECD countries contain detailed and specific anti-abuse provisions in order to avoid that the REIT residence country would lose its taxing rights in respect of the REIT income.

Also the OECD REIT model tax treaty provisions (2007) take into account that the REIT residence country will always levy withholding tax (Commentary to article 10, paragraphs 67.1 to 67.7).

[1] "Tax treaty issues related to REITs in Model Tax Convention on income (OECD 2007).

European Public Real Estate Association
Square de Meeus, 23
1000 Brussels, Belgium
T: +32 (0) 2739 1010 **F**: +32 (0) 2739 1020 **W**. www.epra.com

The domestic REIT laws, together with the OECD model tax treaty provisions on REITs, already enforce sufficient anti-abuse rules to avoid the undesired use of tax treaties by REITs. Therefore, REITs can be seen as a solid and robust concept to prevent the proliferation of offshore property schemes and aggressive international tax structures, being exactly the type of structures that the BEPS Action 6 work is looking to clamp down on.

REITs and LOB Rule

5 We explained to you that REITs working cross border may face serious problems with the proposed LOB rule, in particular in situations where a REIT of Country A, has subsidiaries in Country B (**REIT Subsidiaries**) that will invest in Country C. REIT Subsidiaries may often not qualify for the LOB rule mainly due to the structure of the current "derivative benefits test". Introduction of the LOB rule in its current form would discourage REITs to grow internationally, hamper essential cross-border investment and make the international capital markets less transparent.

6 Therefore, EPRA would like to make the suggestion to delete the requirement that "each intermediate owner is itself an equivalent beneficiary" (delete "provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary" in the proposed article X, paragraph 4, subparagraph a). EPRA is of the view that treaty entitlement should be available if at least 95 per cent of the aggregate voting power and value of the shares of the company claiming the treaty benefits is owned, directly or indirectly, by seven or fewer persons that are classified as equivalent beneficiaries. According to our understanding, this would be in line with the derivative benefits test, included in various US tax treaties.

REITs and PPT

7 Under the proposed Principal Purpose Tests, treaty benefits can be denied if one of the principal purposes of an arrangement is obtaining that benefit. In the current version of the proposed Commentary on article X, paragraph 7, nothing is said about the position of REITs under the PPT (while ample attention is given to CIVs, including an example in the proposed Commentary on CIVs and the PPT[2]).

8 We believe that the specific features of a REIT, the importance of REITs for international capital flows and the elaborate 2007 OECD work on REITs advocate for including special attention to REITS in the proposed commentary on the PPT. This could be done by taking up the following example in the draft Commentary.

Example [..]: RCo, is a resident of State R, RCo is a self-managed "real estate investment trust" (REIT) under the tax laws of State R. RCo holds the shares of SCo, a company resident in State S that owns a portfolio of real estate properties. The shareholders of the REIT are resident in various states. Pursuant to the applicable REIT regime, RCo is

[2] Page 72, 2014 Deliverable: Preventing the granting of treaty benefits in inappropriate circumstances, OECD Base Erosion and Profit Shifting Project, OECD Publishing.

obliged to distribute annually almost all of its profits to its shareholders. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 25 per cent to 5 per cent and REITs are considered to be "residents" for purposes of the said tax convention. RCo's investment decisions take into account the existence of tax benefits provided under State R's extensive tax convention network. A number of investors in RCo are residents of States with which State S does not have a tax convention.

In accordance with the 2007 OECD definition of REITs, RCo's shares are widely held, RCo derives its income primarily from long-term investment in real estate, RCo is under the obligation to distribute most of that income annually, and RCo does not pay income tax on income related to real property that is so distributed. Consistent with the 2007 OECD REIT report, the fact that RCo does not pay tax on its real property income is the result of tax rules in State R that provide for a single level of taxation in the hands of the investors in RCo (with corresponding withholding tax obligations imposed on RCo with respect to its distributions to investors resident in countries other than State R).

State R's domestic REIT legislation contains specific provisions aimed at ensuring that profits cannot be shifted free of tax to foreign investors. RCo's annual mandatory distribution obligation means that taxes are being paid in State R on RCo's profits each year. That is, taxation of investors in RCo is safeguarded and also the recommended tax treatment for REIT dividends under the OECD Model Tax Treaty provisions (see Commentary on article 10, paragraph 67) is included in the tax conventions that State R has concluded. This enables State R to impose – under all circumstances - withholding tax on distributions by resident REITs, like RCo, to foreign shareholders. Given these circumstances, including the taxation of investors in REITs, RCo is not a vehicle of a type that typically would be used for any tax avoidance purpose.

Investors' decisions to invest in RCo are not driven by any particular investment made by RCo, and RCo's investment strategy is not driven by the tax position of its investors. The intent of tax treaties is to provide benefits to encourage cross-border investment. The Commentary on article 10 on "Distributions by Real Estate Investment Trusts" (paragraph 67.2) acknowledges the importance and globalization of investments through REITs. Given the specific context in which RCo (being a REIT) is making the investment in State S, unless RCo's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefits of the convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCo.

Bill in 2/11/15 SFC Mark-up to Amend FIRPTA
to Encourage Equity Investment in U.S. Commercial Real Estate

Background on FIRPTA

In general, developed nations around the world do not impose an income tax on the sale of capital assets by foreign investors, including interests held by foreign investors in real estate corporations, so long as such investors are not conducting a trade or business. However, in the United States, since the 1980s the Foreign Investment in Real Property Act (FIRPTA) has imposed a significant withholding tax on foreigners in conjunction with the sale of U.S. real estate equity. Notably, the U.S. imposes no U.S. tax on most interest payments on most debt paid to debt holders who own less than 10% of the issuer (the "portfolio interest" exception), whether or not the debt is real estate related. As a result of this difference in tax treatment, foreign investment in U.S. real estate is often structured as debt rather than as equity.

This unduly harsh treatment of non-U.S. real estate equity investment arose in the 1980s when Congress enacted FIRPTA after a wave of foreign investment engendered concern that farmland and other U.S. real estate would come under foreign control. (The primary FIRPTA sponsor in the Senate unsuccessfully attempted to repeal the entire law a few years after it went into effect). This tax burden is further increased when the "branch profits tax" is imposed on foreign institutions investing in U.S. real estate.

FIRPTA treats any gain from a non-U.S. person's sale of U.S. real property as if the non-U.S. person was doing business in the United States, and therefore subjects it to full U.S. income tax. To enforce the FIRPTA regime, the tax code requires U.S. persons who acquire real property from non-U.S. investors to withhold a significant tax (usually 10% of the gross proceeds, or 35% of in the case of REIT capital gain distributions) and remit it to the IRS. The FIRPTA rules do not apply to sales of debt secured by real estate such as mortgages.

FIRPTA taxation applies both to sales of direct interests in U.S. real estate as well as to sales of shares of corporations the assets of which primarily consist of U.S. real estate (United States Real Property Holding Corporations, or USRPHCs). However, recognizing that "portfolio" investors of listed real estate companies, such as REITs, are more akin to securities owners than to direct real estate investors, FIRPTA has always exempted sales of stock in a USRPHC that is regularly traded on an established securities market (so long as the seller owns 5% or less of that company).

Finally, REIT capital gains distributions are subject to a 35% FIRPTA withholding tax unless they are paid to 5% or less shareholders of a listed REIT, in which case the distributions are subject to the same withholding rates as ordinary dividends (30% or a lower tax treaty rate -- often 15% or 0% in certain limited cases, such as for a foreign pension fund).

Proposed Change

Portfolio Investors. The 5% "portfolio" investor limit in FIRPTA has become badly outdated. In addition to the 10% ceiling used for portfolio interest mentioned above, the Model U.S. Tax

Convention in use by the Treasury Department for negotiation with foreign governments utilizes a 10% ceiling (rather than 5%) for applying a lower tax rate for individual investors generally as well as for the lower tax rate employed for U.S. REIT dividends paid to foreign "portfolio" investors. So, while most of our U.S. tax treaties with our leading trading partners encourage foreign ownership up to 10%, FIRPTA effectively caps a foreigner's ownership at 5%.

To encourage further foreign equity investment in U.S. REITs (which generates substantial U.S. taxes because of the high dividend payments required under the REIT rules), the bill before the Senate Finance Committee on February 11, 2015 would modify the 5% FIRPTA "portfolio" investor ceiling to conform to the modern 10% treaty standard both for the FIRPTA sales rule and the REIT capital gains rule modified in 2004 while also applying that rule to certain widely-held publicly-traded "qualified collective investment vehicles", which are entities that qualify under a comprehensive income tax treaty with the United States and meet certain detailed reporting requirements.

Revenue Raisers. The budgetary impact of these FIRPTA reforms is offset by five revenue raiser proposals. Most of these proposals generally do not impose any new tax but instead merely collect unpaid FIRPTA taxes. First, the required rate of FIRPTA withholding imposed on the disposition or distribution of a U.S. real property interest would be increased from 10% to 15%, to ensure that FIRPTA withholding collects a sufficient share of amounts owed. Second, USRPHCs would be required to make their FIRPTA status readily accessible to shareholders and the IRS through disclosures in their annual returns. Third, brokers whose clients sell more than 5% of a publicly-traded U.S. real property holding corporation (10% for publicly-traded, foreign controlled REITs upon passage of the bill) would be required to withhold 15% of the proceeds of a disposition of their client's interests in such corporation. Again, each of these provisions imposes no new taxes, but rather collects taxes that are current going unpaid in many cases.

Fourth, the FIRPTA "cleansing rule" exception would no longer apply when a REIT or RIC disposes U.S. real property and claims a dividends paid deduction on the subsequent distribution to shareholders. Finally, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80% owned domestic corporation) are eligible for a dividends received deduction under Section 245 of the Code, dividends from REITs and RICs would no longer be treated as dividends from domestic corporations. The fourth and fifth revenue raisers were included in H.R. 1 in the last Congress.

DESCRIPTION OF THE CHAIRMAN'S MARK OF PROPOSALS RELATING TO REAL ESTATE INVESTMENT TRUSTS (REITs), REGULATED INVESTMENT COMPANIES (RICs) AND THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT (FIRPTA)

Scheduled for Markup
by the
SENATE COMMITTEE ON FINANCE
on February 11, 2015

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

February 9, 2015
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CONTENTS

INTRODUCTION

The Senate Committee on Finance has scheduled a committee markup on February 11, 2015, of proposals relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA). This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the proposals.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Mark of Proposals Relating to the Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA)* (JCX-30-15), February 9, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

A. Proposals Relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), and the Foreign Investment in Real Property Tax Act (FIRPTA)

Present Law

General rules relating to FIRPTA

A foreign person that is not engaged in the conduct of a trade or business in the United States (and is not an individual who is present in the U.S. at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or of other capital assets.[2]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[3] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[4] In the case of a foreign corporation, the gain from the disposition or distribution of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payer of amounts that FIRPTA treats as effectively connected with a U.S. trade or business ("FIRPTA income") to a foreign person generally is required to withhold U.S. tax from the payment. Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on

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[2] Secs. 871(b), 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time of sale, if it was so held within 10 years prior to the sale (sec. 864(c)(7)). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

[4] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

any sale of stock that is regularly traded on an established securities market),[5] and 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation during the applicable testing period.[6] The withholding is generally 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USPRI from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[7] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

U.S. real property holding corporations and five-percent public shareholder exception

USRPIs include not only interests in real property located in the United States or the U.S. Virgin Islands, but also stock of a domestic U.S. real property holding corporation ("USRPHC"), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during a "testing period," which is the shorter of the duration of the taxpayer's ownership of the stock since June 18, 1980, or the five-year period ending on the date of disposition of the stock.[8]

Under an exception, even if a corporation were a USRPHC, a shareholder's shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the seller shareholder held (applying attribution rules) no more than five percent of that class of stock at any time during the testing period.[9] Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of the stock of such corporation.[10] The attribution rules also attribute

[5] Sec. 1445(b). Other excepted circumstances include the sale of a personal residence where the amount realized does not exceed $300,000.

[6] Sec. 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See Sec. 1445(e)(4) and 1445(e)(5).

[7] Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

[8] Secs. 897(c)(1)(A)(ii) and 897(c)(2).

[9] Sec. 897(c)(3). The constructive ownership attribution rules are specified in section 897(c)(6)(C).

[10] If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation. (Sec. 318(c)(2)(C) as modified by section 897(c)(6)(C)). Also, if five percent or more in value of the stock in a

stock ownership between spouses and between children, grandchildren, parents, and grandparents.

"Cleansing rule" exception where corporate gain recognized

An interest in a corporation is not a USRPI if, as of the date of disposition of such interest, such corporation did not hold any USRPIs and all of the USRPIs held by such corporation during the shorter of (i) the period of time after June 18, 1980, during which the taxpayer held such interest, or (ii) the five-year period ending on the date of disposition of such interest, were either disposed of in transactions in which the full amount of the gain (if any) was recognized, or ceased to be USRPIs by reason of the application of this rule to one or more other corporations.[11]

FIRPTA rules for foreign investment through REITS and RICs

Special FIRPTA rules apply to foreign investment through a "qualified investment entity", which includes any real estate investment trust ("REIT"). Prior to January 1, 2015, the term also included certain regulated investment companies ("RICs") that invest largely in U.S. real property interests (including stock of one or more REITs). On and after that date, such RICs are treated as qualified investment entities under FIRPTA only for the purpose of applying FIRPTA to certain distributions the RIC receives or makes that are attributable to its interest in a REIT.[12]

REITs and RICs must satisfy a number of requirements, and are generally taxable as U.S. domestic corporations, but are subject to a modified corporate tax regime that permits the corporation to deduct amounts distributed to shareholders. The shareholders generally include such distributions in income.

Stock of domestically controlled qualified investment entities not a USRPI

If a qualified investment entity is "domestically controlled" (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period[13]), stock of such entity is not a USRPI and a

corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. (Sec. 318(c)(3)(C) as modified by section 897(c)(6)(C)).

[11] Sec. 897(c)(1)(B).

[12] Sec. 897(h)(4)(A)(ii). The provision that expired after December 31, 2014, more generally treating such RICs as qualified investment entities, has expired previously but has subsequently been reinstated through December 31, 2014.

[13] The testing period for this purpose if the shorter of i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, ii) the five-year period ending on the date of the

foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC.[14] Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the "person who is required to include in his return the dividends received on the stock."[15] The IRS has issued a private letter ruling concluding that the term "directly or indirectly" for this purpose did not look through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes "and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity."[16]

FIRPTA applies to qualified investment entity (REIT and certain RIC) distributions attributable to gain from sale or exchange of USRPI's, except for distributions to certain five-percent or smaller shareholders

Code section 897(h) provides that a distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is treated as FIRPTA income.[17] The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of U.S. REITs or RICs.[18] An IRS notice (Notice 2007-55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under sections 301, 302, 331, and 332 (*i.e.*, to both nonliquidating and liquidating distributions, and to distributions treated as sales or exchanges of stock by the investor as well as to dividend distributions) and that the IRS will issue regulations to that effect.[19]

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disposition or distribution, as the case may be, or iii) the period during which the qualified investment entity was in existence. Sec. 897(h)(4)(D).

[14] As noted previously, after December 31, 2014, a RIC is not included in the definition of a qualified investment entity for purposes of this rule permitting stock of a "domestically controlled" qualified investment entity to be sold without FIRPTA tax. Sec. 897(h)(4)(A)(ii).

[15] Treas. Reg. Sec. 1.897-1(c)(2)(i) and Treas. Reg. Sec. 1.857-8(b).

[16] PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.

[17] Sec. 897(h)(1).

[18] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[19] Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of U.S. real property interests are not exempt

Code section 897(h)(1) provides an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located within the U.S., during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.[20] Such distributions that are dividends are treated as dividends from the qualified investment entity,[21] and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS Chief Counsel advice memorandum concludes that such distributions which are not dividends are not subject to tax under FIRPTA.[22]

FIRPTA withholding and reporting of information regarding USRPHC status

A purchaser of a USRPI from any person is obligated to withhold 10 percent of gross purchase price unless certain exceptions apply.[23] The obligation does not apply if the transferor furnishes an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.[24] Also, the obligation does not apply to the purchase of stock of a nonpublicly traded domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or receives a notification that the affidavit is false).[25]

Treasury regulations[26] generally provide that a domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform

from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892-3T, 1.897-9T(e), and 1.1445-10T(b).

[20] Sec. 897(h)(1), second sentence. As noted previously, after December 31, 2014, a RIC is not a qualified investment entity for this purpose.

[21] Secs. 852(b)(3)(E) and 857(b)(3)(F).

[22] AM 2008-003, February 15, 2008.

[23] Sec. 1445.

[24] Sec. 1445(b)(6).

[25] Sec. 1445(b)(3). Other exceptions also apply. Sec. 1445(b).

[26] Treas. Reg. Sec. 1.897-2(h).

that person whether the interest constitutes a USRPI.[27] No particular form is required. The statement must be dated and signed by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his knowledge and belief. If a foreign investor requests such a statement, then the corporation must provide a notice to the IRS that includes the name and taxpayer identification number of the corporation as well as the investor, and indicates whether the interest in question is a USRPI. However, these requirements do not apply to a domestically controlled REIT, nor to a corporation that has issued any class of stock which is regularly traded on an established securities market at any time during the calendar year. In such cases a corporation may voluntarily choose to comply with the notice requirements that would otherwise have applied.[28]

General Code authorization of certain returns by foreign persons

Present law section 6039C provides for returns by foreign persons holding direct investments in U.S. real property interests for the calendar year, to the extent provided by regulations. No regulations have been issued under this section.

Corporate dividends-received deduction for certain U.S. source dividends received from foreign corporations

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends-received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.[29]

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[27] As described previously, stock of a U.S. corporation is not generally a USRPI unless it is stock of a U.S. real property holding corporation ("USRPHC"). However, all U.S. corporate stock is deemed to be such stock, unless it is shown that the corporation's U.S. real property interests do not amount to the relevant 50 percent or more of the corporation's relevant assets. Also, even if a REIT is a USRPHC, if it is domestically controlled its stock is not a USRPI.

In addition to these exceptions that might be determined at the entity level, even if a corporation is a USRPHC, its stock is not a USRPI in the hands of the seller if the stock is of a class that is publicly traded and the foreign shareholder disposing of the stock has not owned (applying attribution rules) more than five percent of such class of stock during the relevant period.

[28] Treas. Reg. sec. 1.897-2(h)(3).

[29] Sec. 243.

Dividends from REITs are not eligible for the corporate dividends received deduction.[30] Dividends from a RIC are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.[31]

Dividends received from a foreign corporation are not generally eligible for the dividends-received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends-received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent-owned U.S. corporation.[32] A 2013 IRS chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends-received deduction if the dividends were attributable to interest income of an 80-percent owned RIC.[33] Treasury regulations section 1.246-1 states that the deductions provided in sections "243… 244… and 245 (relating to dividends received from certain foreign corporations)" are not allowable with respect to any dividend received from certain entities, one of which is a REIT.

Description of Proposals

1. Publicly traded REITs and certain publicly traded qualified shareholder entities that hold REIT stock

In the case of REIT stock only, the proposal increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

The proposal likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales of exchanges of U.S. real property interests, as a dividend, rather than as FIPRTA gain. Any distributions to such 10 percent (or less)

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[30] Secs. 243(d)(3) and 857(c)(1).

[31] Secs. 243(d)(2) and 854(b)(1)(A) and (C).

[32] Sec. 245.

[33] IRS CCA 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its "CFC" status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice.

shareholders that are not dividends (for example, if the qualified investment entity surrendered its stock in a redemption that was not treated as a dividend) would be exempt from U.S. tax.[34]

For these purposes, the attribution rules of section 897(c)(6)(C) are modified to refer to the determination of whether a person holds more than 5 percent of a class of stock that is publicly traded (in the case of a non-REIT shareholder) or more than 10 percent (in the case of a REIT shareholder), as applicable. In either case, however, the proposal retains the present law attribution rules of section 897(c)(6)(C) that trigger attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation.

The proposal also provides that REIT stock held by a qualified shareholder is not a U.S real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of section 897(c)(6)(C)). Thus, so long as that "more than 10 percent" rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA. Also, the REIT may sell its assets and distribute the proceeds in a transaction that is treated as a sale of the qualified shareholder's REIT stock, without the application of FIRPTA. If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) does hold more than 10 percent of such class of REIT stock, then a percentage of the REIT stock held by the qualified shareholder equal to such investor's percentage ownership of the qualified shareholder is treated as a US real property interest in the hands of the qualified shareholder and is subject to FIRPTA.[35]

A qualified shareholder is defined as an entity that is (i) eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program, (ii) a qualified collective investment vehicle (as defined below), (iii) whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), and (iv) that maintains records on the identity of each person who, at any time during the qualified shareholder's taxable year, is the direct owner of more than 10 percent of that principal class of interests.

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[34] This result would follow from application of the conclusion of AM 2008-83, Feb. 15, 2008. See Present Law, FIRPTA rules for foreign investment through REITs and RICs, *supra*.

[35] As one example, if an individual shareholder owns 10 percent of a REIT's stock directly and also owns 10 percent of the stock of a qualified shareholder that in turn owns 80 percent of that REIT's stock (thus indirectly owning another 8 percent of such REIT's stock), such shareholder is deemed to own more than 10 percent (*i.e.*, 18 percent) of that REIT's stock under the proposal. Accordingly, 10 percent (the investor's percentage ownership of the qualified shareholder) of the REIT stock held by the qualified shareholder is treated as a U.S. real property interest.

A qualified collective investment vehicle is defined as an entity that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10 percent of the stock of such REIT[36] (ii) would be classified as a U.S. real property holding corporation (determined without regard to the proposal's rules that exempt REIT stock held by the entity from treatment as a U.S. real property interest), or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

Effective Date

The disposition provisions of the proposal apply to dispositions on and after the date of enactment. The attribution rule change (to refer to the separate 5 percent and 10 percent limitations) is effective on the date of enactment. The distribution provisions apply to any distribution by a REIT on or after the date of enactment which is treated as a deduction for a taxable year of such REIT ending after such date.

2. Domestically controlled definition

For purposes of determining whether a qualified investment entity is domestically controlled, the proposal provides a number of new rules and presumptions.

First, a qualified investment entity shall be permitted to presume that stock held by a holder of less than five percent of a class of stock regularly traded on an established securities market in the United States is held by U.S. persons throughout the testing period except to the extent that the qualified investment entity has actual knowledge regarding stock ownership. Second, any stock in the qualified investment held by another qualified investment entity (I) any class of stock of which is regularly traded on an established stock exchange, or (II) which is a regulated investment company which issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined applying the permitted foregoing presumptions) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (I) or (II) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

Effective Date

The proposal is effective on the date of enactment.

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[36] For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

3. Increase 10 percent FIRPTA withholding to 15 percent

The proposal generally increases the rate of withholding of tax on dispositions and certain distributions of URSPIs, from 10 percent to 15 percent. There is an exception to this higher rate of withholding (retaining the 10 percent withholding tax rate under present law) for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed $1,000,000. Thus, if the present law exception for personal residences (where the purchase price does not exceed $300,000) does not apply, the 10 percent withholding rate is retained so long as the purchase price does not exceed $1,000,000.

Effective Date

The proposal applies to dispositions after the date which is 60 days after the date of the enactment.

4. Required notification of FIRPTA status as a USRPHC, presumption of foreign control of qualified investment entities, and penalty for failure to disclose FIRPTA status

The proposal requires disclosures of USRPHC status, by any corporation that is or was a U.S. real property holding corporation at any time during the five-year period ending on the date on which disclosure is made. Such a corporation must attach a statement regarding its status as a USRPHC within the past five years to its annual tax return, filed on or before the due date (including extensions). Such a corporation is also required to disclose such status on Form 1099s sent to shareholders, in annual reports, on websites, and, in the case of privately-held corporations, on stock certificates.

In the absence of disclosure to the contrary (in such form and manner as the Secretary of the Treasury may prescribe), any qualified investment entity (as defined in section 897(h)(4)) will be presumed for purposes of section 897 to be foreign controlled. Thus, if a foreign person disposes of the stock of a qualified investment entity that is domestically controlled under the rules provided in the proposal, but that does not disclose its domestically controlled status, the disposition is treated as one of stock of an entity that is not domestically controlled, and hence FIRPTA would generally apply to the disposition unless another exception applied.

A penalty is imposed for failure to comply with the USRPHC notification requirements. In the case of a corporation with gross receipts of less than $5,000,000, the penalty is $500,000. The penalty increases to $1,500,000 for corporations with gross receipts of $5,000,000 or more. In the case of a corporation that holds U.S. real property interests with a gross fair market value of $1 billion or more, the penalty is $5 million, increased to $10 million in the case of intentional failure to disclose or report. For purposes of determining gross receipts and gross fair market value under these penalty provisions, related-party aggregation rules apply.

Under regulations prescribed by the Secretary of the Treasury, publicly traded partnerships shall also be subject to these rules.

Effective Date

The proposal takes effect on January 1, 2016.

5. Require FIRPTA withholding by brokers

The proposal amends the FIRPTA withholding rules to provide that in the case of any disposition of stock of a USRPHC involving a broker (as defined in section 6045(c)), such broker shall be required to deduct and withhold a tax equal to 15 percent of the amount realized on the disposition. Certain exceptions apply.

Broker withholding is not required for sales of stock of a domestically controlled qualified investment entity (as defined in section 897(c)(4)) or for stock of a REIT that is not treated as a U.S. real property interest because it is being sold by an entity that is a qualified shareholder under the proposal. With respect to any disposition of any class of stock of a USRPHC which is regularly traded on an established securities market, broker withholding is not required if the transferor, immediately prior to the disposition, holds five percent or less of such class of stock (10 percent or less in the case of REIT stock). For that purpose, brokers are permitted to rely on public statements made by public companies, including statements related to the status of the company as a U.S. real property holding corporation or as a domestically controlled qualified investment entity.[37]

Broker withholding is only required if the broker had actual knowledge (or reasonably should have known) that the disposition was of stock of a U.S. real property holding corporation.

The proposal amends the Code provision that currently exempts from withholding the disposition of a share of a class of stock that is regularly traded on an established securities market, to require the broker withholding in accordance with the foregoing provisions.

Under regulations prescribed by the Secretary of the Treasury, similar withholding rules shall apply to brokers in the case of a disposition of a publicly traded partnership interest where such partnership would be a U.S. real property holding corporation if it were a U.S. corporation.

Effective Date

The proposal applies to dispositions after December 31, 2015.

6. Cleansing rule not applicable to RICs or REITs

Under the proposal, the so-called "cleansing rule" applies to stock of a corporation only if neither such corporation nor any predecessor of such corporation was a RIC or a REIT at any time during the shorter of the period after June 18, 1980 during which the taxpayer held such stock, or the five-year period ending on the date of the disposition of such stock.

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[37] Under the immediately preceding proposal, any qualified investment entity (as defined in section 897(h)(4)) is presumed for FIPTRA purposes to be foreign controlled unless the entity has made a disclosure to the contrary in such form and manner as the Secretary of the Treasury may prescribe.

Effective Date

The proposal applies to dispositions after the date of enactment.

7. Dividends derived from RICs and REITs ineligible for deduction for U.S. source portion of dividends from certain foreign corporations

Under the proposal, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80-percent owned domestic corporation) are eligible for a dividends-received deduction under section 245 of the Code, dividends from RICs and REITs are not treated as dividends from domestic corporations.

Effective Date

The proposal applies to dividends received from RICs and REITs on or after the date of enactment.

B. Estimated Revenue Effects

Fiscal Years [Millions of Dollars]												
2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2015-20	2015-25
-9	-7	-6	-5	-9	-4	1	1	[1]	1	[2]	-41	-38

[1] Gain of less than $500,000.
[2] Loss of less than $500,000.

C. Increase Continuous Levy Authority on Payments to Medicare Providers and Suppliers

Present Law

In general

Levy is the administrative authority of the IRS to seize a taxpayer's property, or rights to property, to pay the taxpayer's tax liability.[38] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[39] the property is not exempt from levy,[40] and the IRS has provided both notice of intention to levy[41] and notice of the right to an administrative hearing (the notice is referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[42] at least 30 days before the levy is made. A levy on salary or wages generally is continuously in effect until released.[43] A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[44]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable when determining whether assessment of tax without following the normal deficiency procedures is permitted.[45]

The CDP notice (and pre-levy CDP hearing) is not required if: (1) the Secretary finds that collection would be jeopardized by delay; (2) the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund; (3) the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served; or (4) the Secretary has served a Federal contractor levy. In each of these four cases,

[38] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[39] *Ibid*.

[40] Sec. 6334.

[41] Sec. 6331(d).

[42] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[43] Secs. 6331(e) and 6343.

[44] Sec. 6321.

[45] Secs. 6331(d)(3) and 6861.

however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[46]

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[47] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments" by the Federal government if the payees are delinquent on their tax obligations. With respect to payments to vendors of goods, services, or property sold or leased to the Federal government, the continuous levy may be up to 100 percent of each payment.[48] For payments to Medicare providers and suppliers, the levy is up to 15 percent for payments made within 180 days after December 19, 2014. For payments made after that date, the levy is up to 30 percent.[49]

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by Treasury's Bureau of Fiscal Service ("BFS"), such as certain Social Security benefit and Federal wage records. When these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. If the taxpayer does not respond after 30 days, the IRS can instruct BFS to levy the taxpayer's Federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or the IRS releases the levy.

Description of Proposal

The proposal provides that the present limitation of 30 percent of certain specified payments be increased by an amount sufficient to offset the estimated revenue loss of the provisions described in Part A, above.

Effective Date

The proposal is effective for payments made after 180 days after the date of enactment.

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[46] Sec. 6330(f).

[47] Pub. L. No. 105-34.

[48] Sec. 6331(h)(3).

[49] Pub. L. No. 113-295, Division B.

JOINT COMMITTEE ON TAXATION
February 10, 2015
JCX-37-15

DESCRIPTION OF THE CHAIRMAN'S MODIFCATIONS TO THE CHAIRMAN'S MARK PROPOSALS RELATING TO REAL ESTATE INVESTMENT TRUSTS (REITS), REGULATED INVESTMENT COMPANIES (RICS), AND THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT (FIRPTA)

(a) Required notification of FIRPTA status as a USRPHC, presumption of foreign control of qualified investment entities, and penalty for failure to disclose FIRPTA status

The modification clarifies that the required disclosures of USRPHC status on an income tax return and on forms 1099 shall be made in such form and manner as the Secretary may prescribe, including electronic filing. The modification also makes clear that in addition to notification to the Internal Revenue Service, and to shareholders through 1099's, the company must provide notice to the public. Notice to the public shall require disclosure in the company's annual reports available on its website, or such other media as the Secretary determines are appropriate in the interests of tax administration.

The modification provides that the penalty amount may be adjusted for inflation.

(b) Require FIRPTA withholding by brokers

The modification clarifies that the proposal requiring withholding by a broker in the case of any disposition of stock of a USRPHC involving a broker (as defined in section 6045(c)) shall apply only to the broker of the seller, not the purchaser.

(c) Cleansing rule

The modification clarifies that the proposal applies to dispositions on or after the date of enactment.

(d) Estimated revenue effects of the chairman's mark proposals as modified

Fiscal Years
[Millions of Dollars]

2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2015-20	2015-25
-9	-7	-6	-5	-9	-4	1	1	[1]	1	[2]	-41	-38

NOTE: Details do not add to totals due to rounding.
[1] Gain of less than $500,000.
[2] Loss of less than $500,000.

GOODWIN PROCTER

REIT ALERT

November 19, 2014

REITs and the Alternative Investment Fund Managers Directive

SPEED READ

The implementation of the Alternative Investment Fund Managers Directive throughout the European Union may have implications for REITs in the United States if they are determined to be alternative investment funds or "AIFs". While the AIFMD rules are evolving, U.S. REITs should be prepared to differentiate themselves from AIFs. This alert examines some areas that should be explored when preparing to make such a distinction.

Introduction

The Alternative Investment Fund Managers Directive, or AIFMD, has now been implemented throughout the European Union. These rules generally impose various registration and reporting requirements on the managers of "alternative investment funds," or AIFs. These requirements apply even to non-EU managers of non-EU AIFs if the AIF is raising equity capital in the EU.

In our October 29, 2014 Client Alert, "The Alternative Investment Fund Managers Directive One Year On–A Guide for Non-EU Managers", we discuss the current state of the AIFMD, its requirements and staged implementation across the EU. In this REIT Alert, we focus on how the AIFMD might impact REITs in the United States and examine the status of REITs as possible AIFs under the new rules.

Capital raising is increasingly global. Even for strictly U.S. domestic REITs, underwriters and placement agents routinely seek to add a European tranche to U.S. offerings. This is true whether the transaction is an underwritten public offering, bought deal and/or private placement. Moreover, for REITs that have acquired, or are considering acquiring, assets in Europe, access to the European real estate investor base may be a key strategic goal or advantage.

The ability to raise equity capital in Europe on an equal footing with all other U.S. public companies is becoming increasingly important to U.S. REITs, of whatever variety or sector. As such, determining whether and how the AIFMD may affect capital raising activities by U.S. REITs in Europe is becoming a gating question when considering capital raising strategies.

As discussed below, the EU rules defining an AIF are broadly written and may implicate business entities and enterprises that would not otherwise have considered themselves "alternative investment funds". Many U.S. REITs whose equity securities are listed for trading on major exchanges would have no reason to consider themselves AIFs any more than operating companies in any industry other than real estate. Unfortunately, the AIFMD provides no blanket exemption for REITs and, to date, among REITs formed in EU jurisdictions, some have concluded that they are AIFs and their managers have registered under the AIFMD. As more fully addressed below, we believe that the structure and operations most publicly-traded U.S. equity REITs will enable them to sufficiently differentiate themselves from the type of investment entity intended to be covered by the AIFMD to conclude that they are not AIFs.

AIFs Under the AIFMD

The primary targets of the directive are unregulated alternative investment funds and their managers. "Alternative investment funds" are defined in the directive as:

*"… **collective investment undertakings**, including investment compartments thereof, which:*

(i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

(ii) [are not EU regulated retail UCITS schemes];"[1]

The European Securities and Markets Authority ("ESMA" – the college of EU regulators whose task it is to create unity of interpretation throughout the EU) has given guidance on the term "collective investment undertaking". It believes that an AIF does <u>not</u> include a vehicle that has a general commercial or industrial purpose, meaning:

"the purpose of pursuing a business strategy which includes characteristics such as running predominantly:

(i) a commercial activity, involving the purchase, sale, and/or exchange of goods or commodities and/or the supply of non-financial services, or

(ii) an industrial activity, involving the production of goods or construction of properties, or

(iii) a combination thereof."[2]

How to distinguish between an investment undertaking and a commercial entity is often not easy. In a series of submissions to EU regulators during the course of the AIFMD drafting and implementation process, the National Association of Real Estate Investment Trusts urged regulators and other participants in the process to clarify generally the scope of the AIFMD and particularly with respect to its application to REITs.[3] In addition, the nature of the AIMFD as an EU directive, rather than an EU regulation, means that it needs to be transposed into law on a country-by-country basis. This has resulted in some differing national interpretations on, among other things, the precise characterization of an AIF.

Is a REIT an AIF?

To decide whether any particular REIT is an AIF, all relevant <u>operational</u> facts and circumstances must be considered. Note that, while counter-intuitive, none of the following non-operational factors is really relevant in making this assessment:

- an entity is a public REIT traded on a national securities exchange;
- REITs are treated as commercial enterprises in the United States and included as such in major equity indices such as the S&P 500; or
- a REIT's income may be treated as operating income rather than investment income for tax purposes.

These may be all true but do not, in and of themselves, automatically mean that a REIT is not an AIF for purposes of the AIFMD. Instead, the focus must be on the operational and commercial characteristics of the company. In the table below, we have summarized general operational and commercial characteristics of typical U.S. publicly traded equity REITs versus those of an AIF. The two criteria we believe to be most significant to the analysis are highlighted in italics, but no single criterion on its own is determinative.

TYPICAL U.S. REIT		AIF
A business which acquires, constructs, refurbishes, develops and provides services related to land and buildings		*An entity that merely holds property to take advantage of changing market prices or (rental) income streams*
Corporation having perpetual existence and one or more classes of permanent equity capital		Fund with a pre-defined finite life, often contingent on the investment goals or status of individual investors
Substantial number of employees from junior personnel to executive board directors to operate the business. Executive directors are paid at the level of executive directors generally		*A largely skeleton staff or no staff at all, with mainly non-executive directors*
Frequent board meetings at which major business is decided		Infrequent board meetings
Little outsourcing of major functions, with appropriate personnel in house to supervise any outsourced activities		Activities frequently outsourced to third parties, including third-party managers and with little ability to supervise outsourced activities
Investment policies that may be changed at the board's discretion		Changes to investment policies normally require some form of investor consent
Typically raises capital for itself by itself to fund its development activities, commercial business strategy and commitments		Typically raises capital through a "sponsor" that plans (itself or through a group member) to make a profit out of the management of the capital raised from third party/external sources
Issues debt in the public and private markets that is subject to ratings agencies review		Typically does not widely issue debt securities to the market and does not have rated debt securities

Whether or not an issuer is an AIF is up to each individual issuer to determine in consultation with its advisors. The criteria listed above are not exhaustive; in any given circumstance there are likely to be additional factors unique to the specific company that may have the effect of making it more or less like an AIF.[4]

European REITs

In this regard, it may be helpful for U.S. REITs to note the views taken by their EU counterparts to date. Property vehicles in the EU generally fall into three distinct categories (although working out which category is relevant for a particular REIT is not necessarily so easy):

- ***True-Commercial Property Vehicles.*** Companies that undertake property construction or development-for-sale businesses are clearly not AIFs. Given the relevant tax rules, though, they are also not likely to be REITs either. Examples in the EU include Persimmon plc and Quintain Estates and Development plc, or Barratt Homes, the house builder.
- ***Property Investment Vehicles.*** Various EU REITs have classified themselves as AIFs under the AIFMD, including, for example, *Standard Life Investments Property Income Trust Limited, Picton Property Income Limited, Tritax Big Box REIT plc* and *Green REIT plc*. In very general terms, the purpose of all four vehicles is to produce income and capital growth by investing in a portfolio of commercial properties; day-to-day activities are often outsourced to an investment manager and administrator (although Green REIT plc is self-managed) and changes to the investment policy may be made only with shareholder approval. Importantly, none of these entities has other than a token number of employees.
- ***"Mixed activity" REITs.*** The classification of these vehicles is more difficult since they undertake a mixture of development and investment activities. Two UK entities are helpful examples, *British Land plc* and *Great Portland Estates plc* — neither has classified itself as an AIF. In both cases, they have a significant number of employees (more than one hundred in each case), with a board of directors that meets frequently to take business decisions. Directors are paid as fully active executives.

Conclusion: Next Steps for U.S. REITs

As noted above, whether or not a U.S. REIT is an AIF is up to the individual company to determine in consultation with its advisors. While the notion of a REIT as a commercial operating company is uniformly accepted in the United States, U.S. REITs will need to affirmatively determine their status under the AIFMD in advance of any equity capital raising activities in the EU.

To be sure, the AIFMD rules are new and regulatory practice is still evolving. Moreover, as noted above, not all EU jurisdictions are necessarily taking exactly the same approach to interpretation or enforcement. Nevertheless, at this point U.S. REITs should at least have a plan. We believe that based on the factors discussed above and in consultation with appropriate advisors, many U.S. equity REITs will be able to sufficiently differentiate themselves from AIFs, taking into account both the general and unique operational characteristics of each individual company.

* * * * *

Please contact any of the attorneys below if you have questions about the issues raised in this REIT Alert.

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[1] Article 4(1)(a).

[2] See page 29 of the Final Report here.

[3] See the documents available at http://www.reit.com/nareit/policy-issues/cross-border-issues/eus-alternative-investment-fund-managers-directive-0.

[4] See, e.g., letter dated January 31, 2013 from the National Association of Real Estate Investment Trusts to ESMA, highlighting other possible differentiating factors between operating businesses and funds, including applicable regulatory regime and valuation metrics.

Authors: Glynn Barwick, Yoel Kranz, Ettore A. Santucci

GET IN TOUCH

For more information about the contents of this alert, please contact:

Glynn Barwick
Counsel
+44 (0) 20 7447 4226
gbarwick@goodwinprocter.com

Yoel Kranz
Partner
212.813.8831
ykranz@goodwinprocter.com

Ettore Santucci
Partner
617.570.1531
esantucci@goodwinprocter.com

RELATED PRACTICES

REITs

Hogan Lovells Alert

January 2015

See note below about Hogan Lovells

Marketing U.S. REITs to European Investors: Are you subject to the Alternative Investment Fund Managers Directive?

Introduction

This guide is aimed at U.S.-domiciled real estate investment trusts (REITs) and their advisers who wish to market in the EU[1] following the implementation of the Alternative Investment Fund Managers Directive (the Directive).

For clarity, this guide focuses on the position under the current law and guidance in the United Kingdom, which may differ from that in other EU member states. REITs should note that it is critical to confer with local counsel in each EU member state before marketing in that EU member state.

This note is written as a general introductory guide only. It should not be relied upon as a substitute for specific legal advice.

Overview

The Directive is part of a suite of complex rules that has a material impact on all funds (wherever domiciled) managed in the EU or marketed in the EU or to any person domiciled or with a registered office in the EU (EU investors).[2]

The Directive applies to "alternative investment funds" (AIFs). This is a broad concept that captures private equity, venture capital, real estate, hedge and infrastructure funds and investment companies. It also captures many investment entities that do not traditionally regard themselves as funds. A REIT that is an AIF must comply with onerous additional obligations in order to market to EU investors.

Despite extensive industry lobbying, there is no "safe harbor" for REITs, some of which may be AIFs. Each REIT will need to carefully consider whether it is an AIF prior to conducting any fundraising[3] activities with EU investors.[4]

This guide provides an overview of the elements of the definition of an AIF that REITs will need to consider in determining whether the Directive applies to them.

Contacts

Michael McTiernan
Partner, Capital Markets, Washington, D.C.
michael.mctiernan@hoganlovells.com
+1 202 637 5684

Nicholas Holman
Partner, Investment Funds, London
nicholas.holman@hoganlovells.com
+44 207 296 5180

Nigel Read
Partner, Corporate, London
nigel.read@hoganlovells.com
+44 207 296 5121

Jeremy Pickles
Senior Associate, Investment Funds, London
jeremy.pickles@hoganlovells.com
+44 207 296 5796

Visit us at
www.hoganlovells.com

Penalties for failure to comply can be severe but vary from EU member state to EU member state – for example, in the United Kingdom "unlawful marketing" may amount to a criminal offense and investors may reclaim their invested money as well as compensation for any losses sustained - so it is critical that REITs understand and adhere to these new rules if they apply.

In the United Kingdom, penalties for "unlawful marketing" apply to the REIT (or any external manager) as well as any underwriter marketing on behalf of the REIT (or any external manager).

What is an AIF?
An AIF is defined as:

- a collective investment undertaking
- that raises capital from a number of investors
- with a view to investing that capital in accordance with a defined investment policy for the benefit of those investors.[5]

There are only a very limited number of exemptions, meaning that a wide range of vehicles could be caught by this definition, including certain REITs. The lack of exemptions in the legislation is deliberate.

That being said, the Directive focuses on investment undertakings, and "ordinary companies"[6] are expressly outside its scope. A typical equity REIT may be able to contend that it is not within the Directive's scope on this basis. However, in order to do so, it will be necessary to carry out an analysis of a particular REIT's characteristics in light of the regulatory guidance available on this issue.

Given its relevance to equity REITs, the remainder of this guide focuses solely on this "ordinary company" issue. If a REIT is an "ordinary company," it will not be considered an AIF; however, if a REIT is not an "ordinary company" or the analysis is not conclusive, then it may be an AIF, and further analysis will be necessary to reach a conclusion.

"Ordinary Companies": A UK perspective
The guidance issued by United Kingdom's Financial Conduct Authority (the FCA), one of the more "business-friendly" of the EU regulators, discusses the concept of an "ordinary company" in detail. It sets out a number of factors that are indicative (but not conclusive) of a business either being an "ordinary company" or an AIF.[7]

Although this guide does not propose to set out these factors in full, and any analysis should consider all applicable facts and circumstances, we believe that when the following factors are present in an equity REIT, this strongly supports the conclusion that the REIT is an "ordinary company" and not an AIF:

- The REIT, like most equity REITs, does not simply hold real estate to take account of changing market prices or income streams, but carries out commercial activities, such as the development or redevelopment of properties.
- The REIT is an operating business with a substantial number of employees over and above the number necessary to simply ensure that investment values of properties are maintained, including employees performing commercial activities such as on-site property management activities and development and redevelopment activities.
- The REIT does not outsource its core operations.
- The REIT's board includes executive officers with executive compensation packages, and the REIT's board or its committees meet more frequently than just quarterly.
- The REIT does not have a defined mechanism for the return of capital to investors, such as a targeted liquidation date.
- The REIT is not marketed as an investment fund.

What do REITs need to do?
Prior to undertaking any fundraising in the EU or with EU investors, it is essential for REITs and their advisers to identify whether the REIT in question is an AIF or not. **We recommend that REITs, with the assistance of their advisers, perform this analysis now rather than at the time of an actual securities offering, when there may be significant time constraints.**

If it is an AIF, the REIT will need to comply with certain parts of the Directive as well as the national private placement regimes of each EU member state in which they wish to market, some of which impose onerous and time-consuming requirements. For example, a REIT that is an AIF wishing to market to German investors will need to, among other things, appoint a depositary to provide certain custody and oversight services and seek approval from the German regulator, a process that can take several months, in each case prior to any marketing.

If the REIT is not an AIF, any promotional activities will need to be carried out in compliance with local securities laws, but the additional burden of the Directive will not apply.

How can Hogan Lovells help?

Hogan Lovells, with its market-leading REIT practice and highly-regarded global investment funds practice with practitioners throughout the EU and the U.S., is uniquely qualified to assist REITs with this analysis.

- Our transactional lawyers, in collaboration with our regulatory practitioners, have already advised many REITs, real estate managers, and real estate trade bodies on their position under the Directive. We have a practical understanding of the regulation and the regulatory environment and extensive experience in the industry.
- We have also advised numerous AIFs and their managers on the impact of the Directive on the operation, management, and marketing of such AIFs. This enhanced insight into the Directive allows us to provide clear guidance about what U.S. REITs need to do to be compliant.

Further information

If you would like further information on the subject matter discussed in this note, please contact your relationship partner at Hogan Lovells or any of the lawyers listed on the right hand side of this alert.

1. For ease of reference, the term "EU" as used in this memorandum includes Norway, Iceland, and Liechtenstein, which together with the 28 member states of the European Union form the European Economic Area.
2. EU Directives do not apply directly across the EU, rather they have to be implemented into the national law of each EU member state, and it is the national law that has effect. Although the legislative intention is that the Directive apply harmoniously across the EU, the national level implementation has resulted in the law being applied inconsistently across the EU. REITs and their advisers therefore cannot rely on the interpretation in one EU member state as applying in another. To minimize this, the European Securities and Markets Authority (ESMA) has published guidelines to aid EU member states in their interpretation and implementation of the Directive, which it can update from time to time.
3. Fundraising by way of an issue of conventional debt securities should not be restricted by the Directive, whether a REIT is an AIF or not.
4. "Marketing" under the Directive has been interpreted in different ways. Certain EU member states require formal registration under the Directive prior to any contact being made with prospective investors; others permit test marketing without compliance, only requiring notification and compliance prior to shares being made available to acquire.
5. We understand that some equity REITs have focused their analyses on the need for a defined investment policy, arguing that a broad investment policy that can be changed without investor approval does not qualify as being "defined". While this argument is persuasive, particularly when compared to a typical real estate fund where a detailed, enforceable, and fixed investment policy is a key component, because the Directive was clearly intended to cover certain hedge funds with similarly broad policies that can be changed without reference to the investors, and because certain regulators have determined these policies to be sufficiently "defined," the position is not certain, and equity REITs should not rely solely on this argument.
6. The term "ordinary company" was replaced in later guidance issued by ESMA by the concept of an undertaking having "a general commercial or industrial purpose". Ordinary company is used in this note for simplicity.
7. The FCA guidance only applies in the United Kingdom. Although the intention is that the Directive is applied in a consistent manner across the EU, it is very possible that some other EU member states will interpret the provisions differently. A REIT proposing to raise funds on a pan-European basis should therefore consider whether to seek advice in respect of each EU member state in which it intends to market.

Atlantic House, Holborn Viaduct, London EC1A 2FG, United Kingdom
Columbia Square, 555 Thirteenth Street, NW, Washington, D.C. 20004, United States of America

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MARKETPLACE FAIRNESS ACT RE-INTRODUCED IN THE SENATE

Yesterday, Senators Mike Enzi (R-WY) and Dick Durbin (D-IL), along with Senators Lamar Alexander (R-TN), Heidi Heitkamp (D-ND), Roy Blunt (R-MO), Jack Reed (D-RI), Bob Corker (R-TN), Sheldon Whitehouse (D-RI), and Angus King (I-ME), introduced the Marketplace Fairness Act, S. 698.

Among other things, the Marketplace Fairness Act would allow states with sales and use tax regimes that meet certain simplification standards to require retailers to collect sales and use taxes from consumers within the state, whether or not those retailers have a physical presence. Additionally, the Marketplace Fairness Act provides an exemption for small businesses and would relieve consumers of having to self-report sales/use taxes they already owe.

The bill introduced today is nearly identical to a proposal that passed the Senate on May 6, 2013 by a vote of 69-27, with two minor changes. First, it would delay implementation for one year after enactment. Second, during the first year it is in effect, sales made during the fourth quarter holiday season would be exempted. If you would like to ask your senator to co-sponsor this important legislation, please click here.

By providing this roadmap for states to gain the ability to collect the sale and use taxes they are already owed, this legislation would provide tax parity for bricksand-mortar retailers and remote internet and catalogue sellers, simplify state tax filing for individuals, and help address state budget shortfalls at no cost to the federal government. On March 3, 2015, Supreme Court Justice Anthony Kennedy in Direct Marketing Ass'n. v. Brohl questioned the continuing validity of the previousSupreme Court decision that prohibited states from collecting sales or use taxes from remote sellers. Legislation such as the Marketplace Fairness Act provides the preferred method to resolve this complex issue.

NAREIT and its members have been supporting legislative changes along these lines since 1999, and NAREIT now serves on the Management Committee of the Marketplace Fairness Coalition. This coalition is comprised of a broad group of businesses and trade associations led by the International Council of Shopping Centers, and it includes the American Booksellers Association, the National Retail Federation, the Retail Industry Leaders Association, the National Association of College Stores, and online retailer Amazon.com.

NAREIT commends the co-sponsors of the Marketplace Fairness Act for their leadership on this important issue. In particular, NAREIT appreciates the tireless efforts of Senators Enzi and Durbin who have championed the need for a level playing field for all retailers for over a decade.

For more information about the Marketplace Fairness Act and related legislation, visit REIT.com.

CONTACT

For further information, please contact NAREIT's VP of Government Affairs Kirk Freeman atkfreeman@nareit.com.