



April 15, 2015

The Honorable Orrin G. Hatch  
Chairman  
215 Dirksen Senate Building  
Washington, D.C. 20510

The Honorable Ron Wyden  
Ranking Member  
215 Dirksen Senate Building  
Washington, D.C. 20510

Filed at [International@finance.senate.gov](mailto:International@finance.senate.gov)

**Re: Comments to the Senate Committee on Finance International Tax Reform Working Group**

Dear Chairman Hatch and Ranking Member Wyden:

The National Association of Real Estate Investment Trusts<sup>1</sup> (NAREIT) welcomes the opportunity to provide comments to the Senate Committee on Finance International Tax Reform Working Group (the Working Group). We look forward to working with the Senators and staff who are participating in the Working Group on ways to modernize our outdated international tax system.



**EXECUTIVE SUMMARY**

NAREIT supports the goals of modifying the U.S. tax system to make U.S. companies more competitive and to encourage job creation and investment in the U.S. while simultaneously limiting inappropriate opportunities for base erosion. As further described below, NAREIT suggests that the Working Group consider the unique nature of the REIT rules in designing any new international tax system because: 1) REITs generally invest overseas for the purpose of generating more current income to distribute to shareholders as they are statutorily mandated to do (contrary to the more prevalent practice of deferring U.S. taxation of retained foreign earnings overseas under our current worldwide international tax system); and, 2) international tax reform could create inadvertent, yet adverse, consequences to REITs if certain design features of a new international tax system were to be enacted.<sup>2</sup>

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<sup>1</sup> NAREIT, the National Association of Real Estate Investment Trusts, 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.

<sup>2</sup> NAREIT has previously discussed some of these issues in its letter dated May 31, 2013 to the Committee on Ways and Means commenting on the [international tax reform discussion draft](#) released on October 26, 2011 by former Chairman Dave Camp (2011 Discussion Draft).



In the event that the Working Group considers a dividend exemption system to replace our current international tax system, similar to the proposal that was included in [H.R. 1, \*The Tax Reform Act of 2014\*](#) (or the 2014 TRA, released on February 26, 2014 by former Ways and Means Committee Chair Dave Camp), NAREIT recommends that REITs be treated similarly to pass-through entities so that REITs would continue to apply current law rather than a dividend exemption system.

However, if it is determined that REITs should be included in a dividend exemption system, NAREIT believes that such a system should provide for the following: 1) REITs should be excluded from any “deemed incorporation” of foreign branches, as well as any tax on accumulated foreign earnings requiring immediate inclusion of such earnings; and, 2) the concept of allowing a shareholder to exclude previously taxed subpart F income (PTI) should be retained.

Further, because a number of the potentially adverse tax consequences for REITs under a dividend exemption system would be due to the treatment of a U.S. REIT’s foreign rental income earned through subsidiaries as subpart F income, we recommend that the Working Group consider a modification to the definition of foreign personal holding company income so that employees of a related company could be considered as employees of the lessor company. Specifically, the subpart F rules treat rents as passive rents if direct employees of the landlord are not involved in the management and operation of the rental property (disregarding the active role of the employees of any related property manager in such operations). Due to local employment laws and practices, often the individuals who provide property management services are employed by a separate property manager affiliate in the group rather than the real estate holding entity.

Accordingly, NAREIT recommends a modification to the subpart F rules so that the services provided by an affiliate could be allowed to be taken into account for subpart F testing as to whether the rents are active, particularly considering that many businesses outside the U.S. are compelled by local rules to house such employees abroad in an affiliate management company.

## **DISCUSSION**

### **A. Background**

#### 1. REITs Generally

Authorized by Congress over 50 years ago, and modeled after mutual funds, REITs represent the easiest way through which investors can invest in professionally managed portfolios of real estate assets. Stock in stock exchange-traded REITs typically is held by retail investors, either directly or indirectly through mutual funds or exchange traded funds. Investing in a diverse, professionally managed portfolio of real estate assets provides all Americans access to, and the



benefits of investing in, large scale income-producing real estate, without the risks and transaction costs associated with investing in individual properties.

Like a mutual fund, a REIT is not subject to entity-level federal income tax on taxable income that it distributes to its shareholders as dividends each year. REIT dividends are taxed at the highest rate applicable to ordinary income. However, to achieve this tax treatment, sections 856 through 860 require a REIT to satisfy several tests related to the nature of the REIT's assets, the sources of its income, its mandatory distributions to its shareholders, and the ownership of its stock.<sup>3</sup> Although REIT income in general is not subject to a corporate-level tax like partnerships and other types of fiscally transparent entities, the REIT income and asset tests, coupled with the mandatory distribution rules, and the fact that REITs may not pass through losses and credits to investors, distinguish REITs from pass-through entities.

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

### a. Gross Income Tests

To ensure that a REIT derives substantially all of its income from real estate related sources, a REIT is required to derive at least 75% of its gross income each year from, *inter alia*: 1) rents from real property; 2) interest on obligations secured by mortgages on real property or on interests in real property; and, 3) gain from the sale or other disposition of real property, including interests in real property and interest in mortgages on real property, that is not “dealer property” (*i.e.*, property held primarily for sale to customers in the ordinary course of business).<sup>4</sup> (75% Gross Income Test). A REIT also is required to satisfy the 95% gross income test. That test requires that a REIT derive at least 95% of its gross income each year from passive sources, including, *inter alia*, any income that is qualifying for the 75% Gross Income Test, interest, dividends, and gains from the sale or other disposition of stock, securities and real estate that is not “dealer property.”<sup>5</sup> (95% Gross Income Test).

### b. Asset Tests

Among other things, on a quarterly basis, 1) at least 75% of the value of a REIT's total assets must be from “real estate” sources (including foreign real estate<sup>6</sup>) (75% Asset Test)<sup>7</sup>; 2) a REIT

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<sup>3</sup> For further detail regarding the positive effects of REITs on the economy and investors, please see NAREIT's submission to the Ways & Means Committee Real Estate, Energy, International, Pensions/Retirement, Debt, Equity and Capital, Education and Family Benefits, Charitable/Exempt Organizations, Financial Services and Small Business Tax Reform Working Groups dated April 15, 2013, available at [http://waysandmeans.house.gov/uploadedfiles/nareit\\_wg\\_comments.pdf](http://waysandmeans.house.gov/uploadedfiles/nareit_wg_comments.pdf).

<sup>4</sup> I.R.C. § 856(c)(3).

<sup>5</sup> I.R.C. § 856(c)(2).

<sup>6</sup> Rev. Rul 74-191, 1974-1 C.B. 170.



cannot own more than 10% of the vote or value in a corporation other than another REIT, a “taxable REIT subsidiary” (TRS) or a wholly owned “qualified REIT subsidiary” (QRS)<sup>8</sup> (10% Asset Test); and 3) the value of securities of all TRSs cannot exceed 25% of a REIT’s assets (TRS Asset Test). A TRS is a fully taxable corporate subsidiary of a REIT. A REIT and affiliated TRSs must elect jointly for the TRS or TRSs to be treated as TRSs.

c. Distribution Test

A REIT must distribute 90% of its “REIT taxable income” (excluding net capital gain) each year (the 90% Distribution Requirement).<sup>9</sup> Like a mutual fund (called a regulated investment company in the Code), a REIT is allowed a dividends paid deduction in computing its taxable income.<sup>10</sup> Thus, a REIT does not pay an entity-level tax on its distributed taxable income, and most REITs distribute 100% of their taxable income. As with mutual funds, the tax burden from a REIT’s activities is borne by the REIT’s shareholders. SEC-registered REITs paid out over \$47 billion in dividends in 2014, most of which were taxed at the ordinary income rate, not the lower rate applicable to qualified dividends. At the end of February 2015, 223 REITs that are listed on stock exchanges had an equity market capitalization of \$953 billion.

A limited exception from the 90% Distribution Requirement is available for certain types of “phantom” or “noncash” income recognized by a REIT.<sup>11</sup> A REIT is not required to distribute “excess noncash income,” which is certain noncash income in excess of 5% of the REIT’s taxable income (excluding net capital gains).<sup>12</sup> The potential sources of “excess noncash income” under section 857(e) include, *inter alia*, original issue discount (OID) and cancellation of indebtedness (COD) income.<sup>13</sup> A REIT, however, is required to pay corporate income tax on any “excess noncash income” that it does not distribute to its shareholders.

Notwithstanding the limited exception for excess noncash income, REITs generally are required by market forces to distribute all of their taxable income, and, as a result, also their phantom income. In order to raise the cash necessary to distribute phantom income as required by the 90%

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<sup>7</sup> I.R.C. § 856(c)(4).

<sup>8</sup> Under section 856(i), a QRS is treated as a disregarded entity of its parent REIT.

<sup>9</sup> I.R.C. § 857(a)(1)(A).

<sup>10</sup> I.R.C. § 857(b)(2)(B).

<sup>11</sup> I.R.C. § 857(a)(1)(B).

<sup>12</sup> I.R.C. § 857(e)(1).

<sup>13</sup> I.R.C. § 857(e)(2). Excess noncash income also includes: 1) “excess inclusion income,” a type of phantom income recognized by a holder of a residual interest in a real estate mortgage investment conduit (REMIC) or a taxable mortgage pool; 2) gain from certain failed section 1031 “like-kind” exchanges; and, 3) rental income accelerated under section 467 (requiring accrual of rental income on a level basis on certain leases with backloaded rent). I.R.C. § 857(e)(2)(A), (B), and (C). In the case of OID, excess inclusion income, and section 467 income, the “excess noncash income” comprises income in excess of the cash actually received on the related investment.



Distribution Requirement, a REIT may incur debt or sell assets it otherwise would hold on a long-term basis. Neither of these alternatives typically is in the best economic interests of the REIT's shareholders. Incurring debt to satisfy the 90% Distribution Requirement will necessarily increase the REIT's leverage beyond what it otherwise would have been, and that increased leverage may make it more difficult for the REIT to survive an economic downturn.

Ultimately, if the recognition of and the failure to distribute phantom income causes a failure of the 90% Distribution Requirement, the REIT will lose its REIT status. This would cause the REIT to be treated as a C corporation that is subject to regular corporate income tax for the year of the failure and for the following four years, unless the REIT obtains the consent of the IRS to maintain its REIT status.<sup>14</sup> The corporate income tax resulting from a failure to satisfy the 90% Distribution Requirement would greatly reduce the distributions the REIT could pay to its shareholders and likely would significantly reduce the value of the REIT's stock. In sum, phantom income can cause significant negative consequences for a REIT and its shareholders.

## **B. REIT Investment Outside of the U.S.**

### **1. Generally**

In Revenue Ruling 74-191, 1974-1 C.B. 170, the IRS concluded that otherwise-qualifying assets do not fail to satisfy section 856(c)(4) merely because the assets are located outside the United States. Several REITs invest in part outside of the U.S. as a way of servicing their tenants, which are global enterprises, teaming with foreign real estate experts and diversifying their asset base.

Of particular concern to REITs when investing outside of the U.S. are the following factors: 1) maximizing the generation of cash for distribution to shareholders, while complying with the 75% Gross Income Test and the 75% Asset Test; 2) complying with the TRS Asset Test; 3) satisfying the 90% Distribution Requirement/shareholder demand for cash, while avoiding phantom income; and, 4) minimizing foreign tax liability, as REITs generally cannot use foreign tax credits.

REITs may invest outside of the U.S. through fiscally transparent entities, including disregarded entities (either limited liability companies or QRSs, partnerships, or foreign entities that "check the box" to be treated as a disregarded entity or as a partnership) or through U.S. or foreign corporate entities.

### **2. REIT Use of Fiscally Transparent Entities**

Specifically, REITs may invest in foreign real estate through a U.S. partnership, limited liability company or disregarded entity or a foreign limited liability entity that "checks the box" to be

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<sup>14</sup> I.R.C. § 856(g)(3) (prohibiting an entity that has failed to qualify as a REIT from electing REIT status for the next four taxable years).



treated as a disregarded entity or as a partnership for U.S. tax purposes. (These entities may be regarded, or corporate, entities for foreign income tax purposes.) By doing so, the REIT achieves immediate and ongoing flow-through of foreign income that maximizes distributions to shareholders and complies with the REIT income and asset tests similar to its investments in U.S. real estate.<sup>15</sup>

In many cases, once a top-tier entity is established, regional investments (*e.g.*, investments in the European Union or throughout Asia) are made through subsidiary disregarded entities in order to achieve operational efficiencies, minimize liabilities, and reduce foreign taxes. Reduction of foreign taxes allows for a greater amount of income to flow through to REIT shareholders. As REITs generally do not claim foreign tax credits and cannot pass such credits through to their shareholders, a reduction in foreign taxes results in REITs being able to distribute more income currently to their shareholders. Thus, the REIT's investments are structured using fiscally transparent entities in order to maximize current income and distributions to shareholders, *not to defer U.S. taxes*.

### 3. REIT Use of Corporate Entities

Although a REIT may prefer to invest overseas through fiscally transparent entities, a REIT may face a number of issues by investing outside of the U.S. through flow-through entities. First, if the foreign entity or the REIT's foreign partner in the foreign entity inadvertently invests in non-qualifying REIT assets or generates non-qualifying REIT income, the REIT's tax status could be jeopardized.

Second, many countries limit the actual cash distributions that can be made to foreign shareholders. Often, this limit will be based on book income (distributable reserves); thus, companies that claim depreciation (that is, non-cash) expense may have book income that is less than its distributable cash flow. Due to typical acquisition structures, book depreciation often exceeds tax depreciation. Although Treasury Regulation § 1.856-3(g) requires a REIT to include its proportionate share of the flow-through entity's income in its taxable income, and the 90% Distribution Test requires the REIT to distribute 90% of such income, the REIT may not have access to the flow-through entity's cash. As a result, the REIT may consider making its overseas investments through entities that are treated as corporations for U.S. tax purposes. Further, some countries require foreign companies like U.S. REITs to invest in real estate located in their countries through entities that are treated as corporations for U.S. tax purposes.

Finally, for those REITs in the hospitality and healthcare industries that lease their real estate to a TRS,<sup>16</sup> the ownership of such real estate by a fiscally transparent entity is somewhat impractical

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<sup>15</sup> Under Treas. Reg. § 1.856-3(g), a REIT is deemed to own its proportionate share of the assets and income of a partnership in which it owns an interest.

<sup>16</sup> See I.R.C. § 856(d)(8)(B).



as it doubles up on audit, tax and other local country fee-heavy requirements. Thus, these REITs often invest overseas through TRSs, subject to compliance with the TRS Asset Test.

Because a REIT only may own up to 10% of a corporation other than another REIT, a QRS, or a TRS, if a REIT invests in a foreign corporate entity, typically the REIT and the foreign corporate entity will elect for the foreign entity to be a TRS. By investing through a TRS, rather than a flow-through entity, the REIT avoids the risk that a foreign flow-through entity inadvertently may invest in non-qualifying REIT assets or generate non-qualifying REIT income that could jeopardize the REIT's tax status. Additionally, the REIT avoids the issue of foreign entities being legally prevented from distributing all of its available cash to the REIT, when the REIT is required to distribute at least 90% of such taxable income.

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

REITs typically do not invest in foreign countries in order to defer the recognition of taxable income. First, in certain cases, rental income earned by the TRSs may be considered subpart F income (if the company earning the rental income is not the same company whose employees are managing the property).<sup>17</sup> Thus, if the REIT is a "U.S. shareholder" of CFCs, the REIT is required by section 951(a)(1)(A)(i) to include in its gross income its pro rata share of the subpart F income, as defined in section 952(a), of any such CFCs. Additionally, as a result of being a U.S. shareholder of CFCs, the REIT is required by section 951(a)(1)(B) to include in its gross income its share of the amount determined under section 956 with respect to each CFC for the relevant tax year (but only to the extent not excluded from gross income under section 959(a)(2)).

If the REIT is not a U.S. shareholder of the CFC, the entity will be considered a passive foreign investment company (PFIC) if it generates sufficient FPHCI. If so, the REIT's tax treatment will

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<sup>17</sup> Foreign personal holding company income (FPHCI), one type of subpart F income, is defined to include "...rents, ... other than...rents and royalties derived in the active conduct of a trade or business and which are received from a person that is not a related person." Section 954(c)(2)(A); Treas. Reg. § 1.954-2(b)(6).

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

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



vary based on whether it has made a qualified electing fund (QEF) election for that PFIC. As a result of being a shareholder in PFICs for which it has made QEF elections, the REIT is required under section 1293(a) to include in its gross income its pro rata share of the ordinary earnings and net capital gain of each such QEF. As a result of being a shareholder in PFICs for which it has not made any QEF elections, a REIT is required to include amounts in income (as ordinary income) pursuant to section 1291.

In either case, the subpart F income will not qualify as 75% Gross Income. However, the IRS has appropriately issued a number of private letter rulings holding that subpart F income inclusions and/or PFIC inclusions qualify as 95% Gross Income.<sup>18</sup>

### **C. 2014 TRA: International Tax Proposals**

As relevant to REITs, the 2014 TRA would have modified current law by generally proposing the following: 1) a dividend exemption system that would exclude 95% of foreign-source dividends from a U.S. parent corporation's taxable income; and, 2) immediate U.S. taxation (with the related tax liability to be paid over eight years if desired) of post 1986-accumulated earnings of foreign subsidiaries.

Unlike the 2011 Discussion Draft, the 2014 TRA did not propose a deemed incorporation rule for foreign branches (the Deemed Incorporation Rule). The Deemed Incorporation Rule would have treated any foreign branch as a separate corporation which is a CFC, and the U.S. corporate shareholder as a "U.S. shareholder" under the CFC rules. A "foreign branch" was defined as "any trade or business of [a] domestic corporation in a foreign country." Although the Deemed Incorporation Rule was eliminated in the 2014 TRA so that branches would continue to be treated as branches, the international tax reforms included in President Obama's [fiscal year 2016 budget proposal](#) would treat branches as CFCs. The Deemed Incorporation Rule, along with the proposed dividend exemption system and the tax on accumulated foreign earnings, are discussed below.

### **D. NAREIT's International Tax Reform Recommendations to the Working Group**

#### **1. Current Law, Rather Than a Dividend Exemption System, Should Continue to Apply to REITs**

As described above, REITs generally structure their foreign operations in a manner that results in current U.S. taxation of foreign income - either through foreign branches or disregarded entities for U.S. tax purposes, or through subsidiary corporations that qualify as TRSs that often generate subpart F rental income. Even to the extent foreign subsidiaries do not generate subpart F rental income recognized as taxable income currently, the 90% Distribution Requirement and market expectations, as a practical matter, pressure REITs to receive and distribute current income

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<sup>18</sup> See, e.g., PLRs 201226004 <http://www.irs.gov/pub/irs-wd/1226004.pdf> and 201246013 <http://www.irs.gov/pub/irs-wd/1246013.pdf>.





earned by lower-tier entities located in the U.S. and overseas. Accordingly, REITs do not raise the issues which are intended to be addressed by a territorial taxation regime such as a dividend exemption system, as they generally do not defer U.S. taxation on foreign operations or retain funds from operations in the foreign branches.

Because of the uniqueness of the REIT rules, proposals to adopt a dividend exemption international tax system such as that included in the 2014 TRA, without careful modification to address the interplay with the REIT tax rules or appropriate carve outs, could inadvertently affect in an adverse way REITs with foreign operations. Furthermore, some of these proposals could alter substantially a REIT's compliance with the gross income and asset tests. As a result, we suggest that any dividend exemption proposal considered by the Working Group (including that proposed in the 2014 TRA) not apply to REITs even though REITs would not be entitled to the benefits of an exemption of CFC dividends from U.S. Federal income tax.

The dividend exemption proposal that was included in the 2014 TRA is limited to owners of CFCs that are C corporations and would not apply to partnerships and other pass-through owners of CFCs. While REITs generally are formed as C corporations, their tax treatment is comparable to that of a pass-through entity (in that tax liability is borne by the entity's owners). Therefore, considering the special challenges discussed above that a dividend exemption system poses for REITs, NAREIT recommends that REITs be excluded from any proposed dividend exemption system and continue to be subject to current law.

However, if it is determined that REITs should be included in any dividend exemption system that the Working Group considers, we make the recommendations described below to mitigate the potentially adverse consequences of applying a dividend exemption system to REITs.

## 2. Any Tax on Accumulated Foreign Earnings Should Not Apply to REITs

Both the 2014 TRA and President Obama's fiscal year 2016 budget proposals include a mandatory tax on accumulated foreign earnings (often referred to as a "transition rule" or "deemed repatriation"). Under this mandatory tax, there would be immediate inclusion in a domestic parent's taxable income of accumulated foreign earnings of CFCs at a specified effective tax rate. Under the 2014 TRA, the rate would be 8.75% on foreign earnings to the extent of the CFC's unrepatriated cash and cash equivalents, while the rate would be 3.5% on the CFC's remaining foreign earnings. Under President Obama's budget, the rate would be 14% on all of the CFC's foreign earnings. At least in the case of the 2014 TRA, previously taxed (subpart F) income and "effectively connected" U.S. source income would be excluded from this income inclusion.

With regard to the 2014 TRA, the split-rate of 8.75% and 3.5% is the result of including accumulated foreign earnings of CFCs in gross income, but allowing a 75% deduction and a 90% deduction, respectively (against the 35% corporate tax rate). President Obama's budget proposal



lacks sufficient detail to indicate whether a similar mechanism would be employed to apply the proposal's 14% effective tax rate to accumulated foreign earnings of CFCs.

For those REITs operating outside of the U.S. and generating qualifying 75% Gross Income that is not considered subpart F income, the immediate inclusion in taxable income of previously deferred foreign earnings would subject these earnings to the requirement that the REIT distribute at least 90% of these earnings. To the extent that the REIT retained (or reinvested) up to 10% of these earnings, it would be required to pay corporate income tax on the earnings.<sup>19</sup> Failing to distribute the remaining 90% of these earnings could result in a loss of REIT status. Consequently, many REITs would be forced to sell assets or borrow money to satisfy this distribution requirement, neither of which necessarily would be in the long term best interests of its shareholders. Furthermore, REIT shareholders generally do not pay tax on the distributions of these earnings at the lower tax rate applicable to qualified dividends.

Thus, because of the interplay of the REIT rules with the mandatory tax on accumulated foreign earnings, the mandatory tax inadvertently would create adverse consequences for REITs. Accordingly, NAREIT recommends that any mandatory tax on accumulated foreign earnings not apply to REITs. Alternatively, NAREIT recommends that REITs be treated, for purposes of any mandatory tax, similarly to S corporations in the 2014 TRA, which generally deferred the imposition of the tax as long as the S corporation maintained its status as an S corporation (in recognition of the fact that S corporations are excluded from the dividend exemption system in the 2014 TRA).

3. Any Partial Dividend Exemption System Should Exclude Previously Taxed Income

The 2014 TRA proposed to retain a modified version of the subpart F rules and to create a dividend exemption system that would allow a domestic corporation that is a U. S. shareholder<sup>20</sup> to deduct 95% of its dividends received from a CFC (a dividends received deduction or DRD). In its release of the 2014 TRA, the Ways and Means Committee indicated that a partial dividend exemption system was included in lieu of a full dividend exemption system accompanied by rules requiring the allocation of U.S. expenses to exempt foreign income.

As we understand it, the interaction of the subpart F rules and a partial dividend exemption system would mean that, if a U.S. shareholder, like a REIT, were required to include \$100 of subpart F income from a CFC in taxable income in year 1, and the CFC distributed a \$100 dividend to the U.S. shareholder in year 2, the U.S. shareholder would have \$5 of taxable income in year 2 ( $\$100 - (95\%)(\$100)$ ). The U.S. shareholder also would recognize \$100 of taxable

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<sup>19</sup> As noted above, I.R.C. § 857(e)(2) allows a REIT to retain a type of phantom income called "excess noncash income." While this type of income is not subject to the 90% Distribution Requirement, the REIT must pay tax thereon. Thus, if a mandatory tax on accumulated foreign earnings did not exclude REITs, at the very least, the foreign earnings that are subject to the tax should be considered excess noncash income.

<sup>20</sup> The 2014 TRA would define a "U.S. shareholder" according to current section 951(b).



income in year 1. The October 26, 2011 discussion draft released by the Ways and Means Committee proposed to repeal current law's exclusion of a CFC's "previously taxed income" (PTI) from taxable income. As discussed below, repealing the exclusion for PTI raises two significant issues for REITs.

First, a partial dividend exemption raises the potential for double taxation for REIT shareholders with CFCs that generate subpart F income.<sup>21</sup> For example, under current law, assume REIT owns 100% of TRS which owns UK property and earns subpart F rental income of \$100 in year 1. TRS distributes \$100 of cash in Year 2. In year 1, REIT includes \$100 in taxable income, distributes \$100 and has no corporate income tax liability. In year 2, REIT has no consequences from TRS' distribution of the \$100 of previously taxed income under current subpart F rules which exclude PTI from taxable income. REIT shareholders would have \$100 of taxable income in year 1.

Applying a 95% partial dividend exemption to the same facts, in year 1, REIT includes \$100 in taxable income, distributes \$100 and has no corporate income tax liability. REIT shareholders have \$100 of income in year 1. In year 2, the REIT would have a \$100 dividend, but because of the repeal of the PTI rules, it only could exclude 95% of the foreign source dividend amount. The foreign-source portion of the dividend is determined based on the ratio of the CFC's undistributed foreign earnings to total undistributed earnings. Undistributed earnings are defined as the earnings and profits of the CFC computed under sections 964(a) and 986. Undistributed earnings include earnings previously included by the US shareholder under subpart F. This would result in these earnings being taxed currently and again upon repatriation, subject to the 95% DRD. A non-REIT U.S. shareholder would be subject to an additional tax on subpart F income of 1.25% (assuming a corporate tax rate of 25%).

The REIT could exclude \$95 of the \$100 dividend, leaving it with \$5 of taxable income. If it distributes the \$5, it would have no corporate income tax liability, but its shareholders have another \$5 of income, \$5 more than under current law. Also, unlike non-REIT C corporations, REIT shareholders would not benefit from a lower income tax rate – their top ordinary income tax rate is 39.6% (plus a potential 3.8% surtax on dividend income).

Additionally, if the partial dividend exemption is available only to domestic C corporations, then dividends received by U.S. partnerships would be subject to U.S. tax at the partner level and not eligible for the exemption. Many REITs, particularly listed REITs, own no assets directly other than an interest in an operating partnership that owns and operates all of their assets (these REITs are known as UPREITs). It appears that the potential for double taxation would be even more extreme in this structure.

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<sup>21</sup> Some have queried whether REITs would be allowed to claim the DRD. Under current section 243, which provides for a DRD in certain cases, a dividend from a REIT is not considered a "dividend." Presumably, a full or partial dividend exemption would apply to dividends received by a REIT.



Double taxation would result through the combination of repealing the PTI rules and excluding from gross income only 95% (or some other percentage less than 100%) of the CFC's distributions. Accordingly, in order to avoid this double taxation, we recommend that the PTI rules be retained, at least for REITs, in any dividend exemption system that may be considered by the Working Group.

The second issue for REITs with regard to eliminating the PTI rules is that a (full or partial) dividend exemption in the form of a deduction (rather than an exemption) may raise compliance issues for REITs with respect to the 95% Gross Income Test. Thus, income under current law that is excluded from gross income (*e.g.*, PTI) now would be included in income (and may be considered 95% Gross Income), which could skew the REIT's gross income test results, thereby potentially affecting REIT status.

#### 4. Any Dividend Exemption System Should Not Include The Deemed Incorporation Rule

Although the 2014 TRA did not include the Deemed Incorporation Rule, because it was included in the 2011 Discussion Draft, it is possible that this Rule may be considered as part of a Dividend Exemption System. NAREIT urges the Working Group not to include the Deemed Incorporation Rule in any dividend exemption system (or, at the very least, not to apply it to REITs).

While the Deemed Incorporation Rule should have no effect on a REIT's foreign investments currently structured as corporations, it raises a number of issues for REITs that invest in foreign countries through branches and other fiscally transparent arrangements.

First, the Deemed Incorporation Rule may result in a "deemed sale" under section 367(a) with respect to which phantom gain would require to be recognized and distributed.<sup>22</sup> While section 367(a)(3) would exempt from deemed sale treatment those deemed transfers of assets that are used by such a foreign corporation "in the active conduct of a trade or business outside the United States," as noted above, it is likely that, in many cases, the assets of entities currently treated as branches of a REIT would not be considered active for purposes of this rule. Of course, since the entities currently are fiscally transparent, this issue is not relevant under current law.

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<sup>22</sup> It is unclear whether section 367 would apply to the deemed incorporation of a branch, and it would be helpful if the Deemed Incorporation Rule (if proposed) would clarify that section 367 treatment would not apply. Specifically, it would be helpful to clarify that the deemed incorporation of a REIT's wholly-owned branch would continue to be treated as a QRS, and section 367 deemed sale treatment did not apply. (Note that this issue is generally not applicable in the umbrella partnership REIT context, when a REIT owns the majority interests in an operating partnership, and the operating partnership owns and operates all of the "REIT's" properties.) For purposes of this discussion, however, this letter describes the presumably inadvertent, but adverse, consequences if section 367 deemed sale treatment did apply.



Second, the Deemed Incorporation Rule could cause the REIT to fail the 10% Asset Test because the REIT would be treated as owning more than 10% of the securities of another corporation.<sup>23</sup> While the REIT could make a TRS election for these entities to be treated as TRSs, the TRS Asset Test may limit the REIT's ability to do so.

Third, the Deemed Incorporation Rule would cause income that currently qualifies for the 75% Gross Income Test to be converted into, at best, income qualifying for the 95% Gross Income Test. As noted above, income of fiscally transparent REIT investments likely consists mostly of rental income that qualifies as 75% Gross Income. If the fiscally transparent entity were a corporation, its rental income may be viewed as subpart F income, and the REIT would have to include in income either its subpart F inclusions or its PFIC inclusions.

Additionally, because the former fiscally transparent entity's income and assets no longer would be flowing through to the REIT for federal tax purposes based on Treasury Regulation § 1.856-3(g), the REIT would have less gross income, which could affect the calculation of both the 75% and 95% Gross Income Tests. Similarly, the disregarded entities' assets that currently are viewed as qualifying assets for purposes of the 75% Asset Test would be converted into non-qualifying assets for such test.

Fourth, currently disregarded loans to foreign disregarded entities would become "regarded" loans that, if unsecured, could result in additional 95% Gross Income to the REIT, again potentially affecting its REIT qualification.<sup>24</sup>

In sum, REITs that invest outside of the U.S. through fiscally transparent entities are doing so in order to maximize current distributions to shareholders and not for the purposes of income deferral. Because of the various issues raised by the Deemed Incorporation Rule, we recommend that any dividend exemption system that the Working Group considers follow the 2014 TRA by continuing to treat foreign branches as branches or, if the Deemed Incorporation Rule is included, excluding REITs from its application.

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<sup>23</sup> If the fiscally transparent entity is currently 100% owned by the REIT, presumably the entity would be converted into a QRS, which would not raise an asset test issue for the REIT. If the fiscally transparent entity currently is not 100% owned by the REIT, the REIT and the entity could elect for the entity to be a TRS, but no more than 25% of the REIT's total assets can consist of TRS securities without being disqualified as a REIT.

<sup>24</sup> Another potential issue is whether all of a REIT's foreign branches would be viewed as engaged in a "trade or business" in a foreign country, and, if not, how the Deemed Incorporation Rule would apply. As noted above, not all of a REIT's foreign branches will have employees and/or significant activities on their own, and, therefore, may not be considered engaged in a trade or business. Presumably, such entities would continue to be treated as fiscally transparent entities. It would be helpful to have this issue clarified if the Deemed Incorporation Rule is included in a dividend exemption system.



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

Respectfully submitted,

A handwritten signature in black ink that reads "Tony M. Edwards". The signature is written in a cursive style with a large, stylized initial "T".

Tony M. Edwards  
Executive Vice President & General Counsel

