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October 7, 2016

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CC:PA:LPD:PR (REG-134016-15)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20224

**Re: Proposed Regulations under Section 355 Concerning Device and Active Trade or Business**

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity to offer comments regarding the proposed regulations entitled "Guidance under Section 355 Concerning Device and Active Trade or Business" (REG-134016-15) (the Proposed Regulations).

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. We represent a large and diverse industry including equity REITs, which own commercial properties, mortgage REITs, which invest in mortgage securities, REITs traded on major stock exchanges, public non-listed REITs and private REITs. U.S. REITs collectively own nearly $2 trillion of real estate assets and, by making investment in commercial real estate available in the form of stock, our REIT members enable all investors – importantly, small investors – to achieve what, once, only large institutions and the wealthy could.

## EXECUTIVE SUMMARY

NAREIT recommends that the IRS and Treasury Department modify the Proposed Regulations as follows.

First, NAREIT recommends amending the Proposed Regulations to revert to a "device" test based on "investment assets," rather than the new categories of "Business Assets" and "Non-Business Assets."

Second, NAREIT recommends that the IRS and Treasury Department modify the Proposed Regulations to exempt transactions described in section 355(h)(2)(A) of the Internal Revenue Code of 1986, as amended (relating to distributions of REITs by REITs), from the application of the heightened scrutiny of Prop. Treas. Reg. § 1.355-2(d)(2)(iv) and the *per se* rule of Prop. Treas. Reg. § 1.355-2(d)(5).[1]

Third, NAREIT recommends that the IRS and Treasury Department expand the "Business Assets" test in the Proposed Regulations for purposes of the "device" test under section 355 to include real estate owned by a REIT (and certain of its affiliates), without regard to whether such real estate would otherwise qualify as used in an active trade or business of the REIT.

Finally, NAREIT recommends that the IRS and Treasury Department include an example in the final regulations to demonstrate the application of the "anti-abuse" rule of Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(E) (not taking into account a transaction or series of transactions undertaken with a principal purpose of affecting the Nonbusiness Asset Percentage). In particular, NAREIT requests that an example be included exempting from the Proposed Regulations' anti-abuse rule the case in which a REIT begins, no later than one year before a distribution, to self-manage properties that had been externally managed.

## DISCUSSION

### *A. Background*

The Proposed Regulations would make significant changes to one of the factors to be taken into account in determining whether a distribution by a corporation of its subsidiary was used principally as a device within the meaning of section 355(a)(1)(B). Under the regulations currently in effect, the determination of whether a transaction was used principally as a device takes into account the nature, kind, amount and use of the assets of the distributing and the controlled corporations (and corporations controlled by them) immediately after the transaction.[2]

Moreover, the current regulations specify that the existence of assets that are not used in a trade or business that satisfies the requirements of section 355(b) is evidence of a device.[3] For this purpose, assets that are not used in a trade or business that satisfy the requirements of section 355(b) include, but are not limited to, cash and other liquid assets that are not related to the reasonable needs of a business satisfying such section.[4] The strength of the evidence of a device depends on all the facts and circumstances, including, but not limited to, the ratio for each corporation of the value of assets not used in a trade or business that satisfy the requirements of section 355(b) to the value of its business that satisfies such requirements.[5] A difference in the ratio described in the preceding sentence for the distributing and controlled corporation is ordinarily not evidence of device if the distribution is not *pro rata* among the shareholders of the

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1 Unless otherwise provided, all references to "section" in this letter shall be to the Code.
2 Treas. Reg. § 1.355-2(d)(2)(iv)(A).
3 Treas. Reg. § 1.355-2(d)(2)(iv)(B).
4 *Id.*
5 *Id.*

distributing corporation and such difference is attributable to a need to equalize the value of the stock distributed and the value of the stock or securities exchanged by the distributees.[6]

The Proposed Regulations would introduce a distinction between "Business Assets" and "Nonbusiness Assets," with the former defined as gross assets used in one or more "Businesses," including cash and cash equivalents held as a reasonable amount of working capital for one or more "Businesses."[7] A "Business," in turn, would be defined as an active trade or business, within the meaning of section 355(b) and Treas. Reg. § 1.355-3, without regard to, *inter alia*, the requirements relating to the active conduct throughout the five-year period preceding a distribution and acquisitions during such period (an ATB).[8]

In other words, any assets that qualify as used in an active trade or business, within the meaning of section 355(b) and Treas. Reg. § 1.355-3, regardless of the period during which such trade or business has been conducted, would be considered Business Assets under the Proposed Regulations. Nonbusiness Assets would be a corporation's gross assets other than its Business Assets.[9] The Proposed Regulations would require taxpayers to determine the amount of Business Assets and Nonbusiness Assets owned or deemed owned by the distributing corporation and the controlled corporation and to compare their relative "Nonbusiness Asset Percentages" with each other and would specify under what circumstances such ownership and such percentage are considered to be evidence of a device.[10] In addition, in certain cases involving the separation of Business Assets from Nonbusiness Assets, a transaction would be considered to have been used principally as a device.[11]

The requirement to distinguish between Business Assets and Nonbusiness Assets differs from the approach that the Treasury Department and the IRS had set forth in Rev. Proc. 2015-43.[12] In Rev. Proc. 2015-43, certain of the rules of the Proposed Regulations were foreshadowed. That prior guidance had focused on investment assets (using a modified section 355(g) definition)[13] of a corporation as assets that may raise device concerns.

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6 *Id.*

7 Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(B)(2).

8 Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(B)(1).

9 Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(B)(3).

10 Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(C).

11 Prop. Treas. Reg. § 1.355-2(d)(5).

12 (2015-40 I.R.B. 467) (now incorporated into Rev. Proc. 2016-3 (2016-1 I.R.B. 126)) and Notice 2015-59 (2015-40 I.R.B. 459).

13 For purposes of Rev. Proc. 2016-3, "investment assets" has the meaning given such term by section 355(g)(2)(B), except as follows: (i) in the case of stock or securities in a corporation any stock of which is traded on (or subject to the rules of) an established financial market within the meaning of Treas. Reg. § 1.1092(d)–1(b) (publicly traded stock), Treas. Reg. § 1.355(g)(2)(B)(iv) is applied by substituting "50-percent" for "20-percent;" (ii) except as provided in clause (iv) of this sentence, an interest in a publicly traded partnership (as defined in section 7704(b), regardless of whether such partnership is treated as a corporation pursuant to section 7704(a)) is treated in the same manner as publicly traded stock; (iii) except as provided in clause (iv) of this sentence, an interest in a partnership that is not a publicly traded partnership is treated in the same manner as stock which is not publicly traded stock; and (iv) in the case of an interest in a partnership (other than a publicly traded partnership treated as a corporation pursuant to

However, in the preamble to the Proposed Regulations, the Treasury Department and the IRS announced that, after further study, the Treasury Department and the IRS had determined that investment assets as defined in such prior guidance "may include certain assets that do not raise device concerns, such as cash needed by a corporation for working capital, and may not include other assets that do raise device concerns, such as real estate not related to the taxpayer's Business."[14] The Treasury Department and the IRS then stated that they had determined that "focusing on Nonbusiness Assets, as defined in the proposed regulations, is a better method of evaluating device or nondevice as compared to using investment assets as described in Rev. Proc. 2016-3 and Notice 2015-59."[15]

## ***B. Recommendations***

### **1. Revert to a Test Based on Investment Assets**

In 2005, Congress enacted section 355(g) to address certain "cash-rich" split-offs. The provision was aimed at redemptions of a distributing corporation's shareholders with a controlled corporation that was loaded with cash or other liquid assets. Section 355(g) defined the assets that raised concern as investment assets to include cash, stock or securities or other liquid financial instruments[16] and drew a line at two-thirds or more of the fair market value of the assets of the relevant corporation.[17]

We believe that the Treasury Department and the IRS should, as they had done in Rev. Proc. 2015-43 (now incorporated into Rev. Proc. 2016-3) and Notice 2015-59, take into account cash, stock or securities or other liquid financial instruments in determining whether evidence of device exists.

Although section 355(g) is an independent requirement for section 355(a) treatment, the concerns animating its enactment are similar to those relevant to the "device" and ATB requirement in the Proposed Regulations. Drawing a distinction between Business Assets and Nonbusiness Assets under the device test overlaps substantially with the rules of section 355(g). NAREIT believes that two separate provisions addressing the same asset-based concerns that can potentially result in different outcomes should be avoided in the sound administration of the tax laws, as it is much clearer for taxpayers and more administrable for IRS examining agents to deal with concerns about the nature of the corporation's assets under a single provision and a single test.

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section 7704(a)), the active trade or business of which is taken into account by the distributing corporation or the controlled corporation for purposes of section 355(b), or would be taken into account without regard to the five-year requirement of section 355(b)(2)(B), clauses (ii) and (iii) of this sentence do not apply. Rev. Proc. 2016-3, § 5.01(5).

14 Guidance Under Section 355 Concerning Device and Active Trade or Business, 81 Fed. Reg. 46,004, 46,007 (July 15, 2016).

15 *Id.*

16 See section 355(g)(2)(B).

17 See section 355(g)(2)(A)(i).

We therefore think it appropriate to conform to the Congressional distinction between assets that raise concerns and those that do not. Rev. Proc. 2015-43 (now incorporated into Rev. Proc. 2016-3) and Notice 2015-59 adopted the approach that we recommend. Inventing entirely new categories of so-called Business Assets and Nonbusiness Assets has little statutory grounding (especially when such so-called Business Assets are not ATB assets), and could give the appearance of attempting to override the explicit and relatively recent Congressional guidance in section 355(g). In addition, as we discuss in more detail below, the Business Assets/Nonbusiness Assets distinction raises a number of practical issues, especially in the REIT context.

### 2. **Exempt Distributions Described in Section 355(h)(2)(A) from the Device Test-Aspects of the Proposed Regulations**

On December 18, 2015, the President signed into law the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), which was enacted as part of Pub. Law No. 114-113, the "Consolidated Appropriations Act, 2016. Section 311(a) and (b) of the PATH Act added to the Code sections 355(h) and 856(c)(8), respectively. Section 355(h)(1) of the Code provides that section 355 shall not apply to a distribution if either the distributing corporation or the controlled corporation is a REIT. Section 355(h)(2) provides exceptions permitting a REIT to distribute the stock of another REIT or of a TRS under certain conditions. Section 856(c)(8) provides that a corporation may not elect REIT status during the ten-year period following a section 355 distribution if such corporation was the distributing corporation or the controlled corporation in that distribution.

Thus, in general, in enacting section 355(h), Congress evidenced a concern about the tax-free separation of assets of a corporation not qualifying as a REIT into those assets that could be held by a REIT and those that could not be so held, but it also evidenced that the distributions described in section 355(h)(2) do not pose a particular concern. This is consistent with the original intent of Congress when enacting the regime relating to REITs, namely to provide for an investment vehicle taxed at a single level that is accessible to the general public to make investments in real estate.[18]

In addition, the policy concerns undergirding Rev. Proc. 2015-43 (now incorporated into Rev. Proc. 2016-3) or the Proposed Regulations, such as policing end-runs around the repeal of *General Utilities*, simply have no applicability to REITs, which are effectively entities generally taxed only at the shareholder level. Further, REITs already have to satisfy a highly detailed regime of requirements, not just those under section 856, for qualifying or continuing REIT status, but also under section 355(h), and the temporary and, if adopted in final form, proposed regulations under section 337(d), all of which already adequately enforce the protection of the tax base of C corporations. One of these requirements is that REITs generally must distribute, on an annual basis and in distributions qualifying for the dividends-paid deduction, at least 90% of their real estate investment trust taxable income for the taxable year (determined without regard to the deduction for dividends paid (as defined in section 561) and by excluding any net capital

[18] *See* H.R. REP. NO. 2020, 86th Cong., 2d Sess. at 3–4, 6 (1960).

gain). In fact, most SEC-registered REITs distribute at least 100% of their real estate investment trust taxable income for each taxable year.[19] In light of this legal requirement and the practice adopted by most REITs, we believe that it is unlikely that distributions of REITs by REITs ordinarily raise significant device concerns, since it is unlikely that such distributions, followed by the sale of REIT shares, would have the effect of converting what would otherwise be ordinary dividend income into income taxed as capital gains.[20]

For these reasons, we believe that the Treasury Department and the IRS should exempt the transactions described in section 355(h)(2)(A) (relating to distributions of REITs by REITs) from all the device aspects of these new Proposed Regulations (that is, the proposed amendments to Treas. Reg. § 1.355-2, including Prop. Treas. Reg. §§ 1.355-2(d)(2)(iv) and 1.355-2(d)(5), that would amend Treas. Reg. § 1.355-2). It should be noted that this proposal would not exempt REITs from the currently applicable ATB rules, the 5% ATB requirement in Prop. Treas. Reg. § 1.355-9 and the currently applicable device rules. Rather, it would exempt REITs from the heightened device and *General Utilities* requirements (including the *per se* rule of Prop. Treas. Reg. § 1.355-2(d)(5)) when the distribution already satisfies other applicable requirements (such as section 355(h) and section 337(d)). We believe, however, that given the special nature of REIT-to-REIT spin-offs, the application of the numerical tests of the Proposed Regulations (Prop. Treas. Reg. § 1.355-2(d)(2)(iv)) and, especially, the *per se* rule (Prop. Treas. Reg. § 1.355-2(d)(5)) are inappropriate to apply to such situations.

### 3. Expand the Definition of Business Assets

We believe that the limitation of Business Assets to those that would satisfy the ATB requirement but for the five-year period is unduly restrictive. In particular, many REITs could hold real estate assets that would, because of the special circumstances of the REIT industry and the real estate business, not qualify as an ATB but would nonetheless not pose any potential for abuse relating to the device-requirement.

By way of background, it is common that modern REITs are organized in so-called Umbrella Partnership REIT (UPREIT) structures in which a publicly traded REIT owns, as its sole significant asset, a significant (most often, majority) interest in a subsidiary partnership (called an Operating Partnership, or OP) that owns real property and manages and operates such property with its own employees. Unrelated partners own the remaining interests in the subsidiary partnership, usually as a result of having contributed property in exchange for such interests.[21] In addition, it is worth noting that, because REITs must comply with detailed rules regarding the types and amounts of income they may earn, most REITs establish taxable REIT subsidiaries (TRSs) to earn income from activities otherwise not permitted to be earned by a REIT directly, such as for the performance of management services for properties owned by

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19 *See* https://www.reit.com/sites/default/files/1099/HistoricalDividendAllocationSummary.pdf .

20 *See also* Treas. Reg. § 1.355-2(d)(5)(ii).

21 *See* Treas. Reg. § 1.701-2(d), Example 4, in which the government concluded that these anti-abuse partnership regulations should not apply to the typical UPREIT transaction.

third parties or the performance of "non-customary" services to tenants of properties owned by the REIT.[22] Independent contractors serve a similar role.[23]

*Example 1*. A REIT conducts a real estate business through an OP that owns many real estate assets that are actively conducted by the OP. However, the OP also holds real estate assets that are managed by a TRS of the OP as well as real estate assets that are managed by independent contractors. Because such assets are managed by the TRS and independent contractors, they are not an ATB of the OP (or attributed to the REIT under Rev. Rul. 2007-42). If a partnership that owns these managed real estate assets not managed by the OP and the TRS were transferred to a controlled corporation and the controlled corporation was distributed by the REIT, such assets would not count as Business Assets.

*Example 2*. A REIT conducts a real estate business. In addition to its ATB of managing the construction and development of office buildings and actively renting out office space in the metropolitan area in which it is headquartered, it owns land and buildings that are currently net leased to third parties that do not constitute ATBs, the latter real estate being located in a new "frontier" metropolitan area that the REIT is entering. The REIT intends to redevelop the building opportunistically (as soon as the market permits) when the current net lease, which has three additional years to run, comes to an end, and such redevelopment efforts are integral to its business model. However, such an asset would not count as a Business Asset because it would not currently qualify as used in an ATB.

*Example 3*. A REIT conducts a real estate business. The REIT has traditionally focused exclusively on buildings providing only office space, and the REIT has an ATB of developing such buildings and actively renting and managing them. Because the REIT's management believes that it would be prudent to diversify its holdings, the REIT has recently acquired high-end apartments. Since the REIT's employees are not expert in managing such properties, the REIT has hired independent contractors to do so. Until the time at which the REIT will be able to attract employees to manage its apartments, such properties would not count as Business Assets.

*Example 4*. A lodging REIT owns hotels. Under the applicable REIT rules,[24] it must lease its hotels to a TRS,[25] and the TRS must engage an eligible independent contractor to operate the hotels. Although the REIT's hotel business may not be considered as qualifying as an ATB

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[22] *See* section 856(d)(1)(B) and section 856(d)(2)(C).

[23] *See* section 856(d)(3).

[24] Income attributable to the extensive provision of maid services (and similar services provided to hotel guests) is not considered qualifying "rents from real property" for REIT purposes. *See* Rev. Rul. 98-60 (detailed explanation). However, the REIT Modernization Act, Sections 541-71 of Pub. L. No. 106-70, the Ticket to Work and Work Incentives Improvement Act of 1999, specifically enacted provisions that allow hotel REITs to earn qualifying rent from hotel leases to their TRSs, provided that the TRSs engage an eligible independent contractor to manage and/or operate these hotels. Congress enacted similar rules for health care REITs in the REIT Investment Diversification and Improvement Act of 2008 (RIDEA), Pub. L. No. 110-289, §§ 3031-71.

[25] Section 856(d)(8)(B).

(because the hotels must be managed by third parties), hotels could be considered Business Assets.

We believe that the assets described in the examples above ought to be treated as Business Assets, consistent with the policies articulated in the proposed regulations. Unlike passive assets, they are not easy to value, usually not publicly traded and do not provide easy liquidity. Therefore, they do not present any potential for abuse. Instead, they are integral to the business of REITs. We therefore respectfully submit that the Business Assets test should be expanded to include real estate owned by a REIT, without regard to whether such real estate would otherwise qualify as used in an ATB of the REIT. To implement this proposal, the definition of Business Assets could be expanded to included assets which are “REIT-Connected Real Estate,” which could be defined as follows:

> **REIT-Connected Real Estate.—***REIT-Connected Real Estate* means real estate that is owned by a REIT or owned by a member of the qualified group of such REIT (within the meaning of Reg. § 1.368-1(d)(4)(ii), and taking into account the rules set forth in Treas. Reg. § 1.368-1(d)(4)(iii), but replacing the phrase “80 percent” with the phrase “50 percent” in each instance in which it occurs in section 368(c) when incorporating section 368(c) in the application of the rules set forth in Reg. §§ 1.368-1(d)(4)(ii) and 1.368-1(d)(4)(iii)).

We note that we do not believe that the types of real estate described in the examples above (and covered by the suggested definition of REIT-Connected Real Estate) should qualify as being used as part of an ATB under Treas. Reg. § 1.355-3[26] or Prop. Treas. Reg. § 1.355-9. Instead, we request that these types of real estate qualify as Business Assets for purposes of the device test in Treas. Reg. § 1.355-2(d) (and Prop. Treas. Reg. § 1.355-2(d)). This request follows especially in light of the newly proposed *per se* rule in Prop. Treas. Reg. § 1.355-2(d)(5), which would cause certain transactions involving the separation of Business Assets from Nonbusiness Assets to be considered to have been used principally as a device, notwithstanding the presence of nondevice factors or other facts and circumstances and subject to only limited exceptions.

### 4. <u>**Provide an Example to Demonstrate the Application of the Anti-Abuse Rule in the Proposed Regulations**</u>

In addition, we think that, given the definition of a Business, as described above (*i.e.*, an ATB without regard to the five-year requirement) and in light of the anti-abuse rule in Prop. Treas. Reg. § 1.355-2(d)(2)(iv)(E), the Proposed Regulations could lead to uncertainty in scenarios in which Nonbusiness Assets would be converted into Business Assets in close temporal proximity to a distribution or otherwise in transactions related to a distribution (including in transactions entered into in anticipation of a distribution). For example, in Example 3 above, the REIT could begin to self-manage properties that were previously externally managed. We therefore request

26 Thus, in order to meet the section 355 requirements, a REIT that owned, for example, undeveloped land still would need to satisfy, among other things, the requirement that such land be part of an ATB.

that the Treasury Department and the IRS include an example demonstrating that such a conversion, if occurring no later than one year before a distribution, would not be disregarded (under the anti-abuse rule or under other provisions of these Proposed Regulations) and that such assets, after such conversion, would be respected as Business Assets for purposes of Prop. Treas. Reg. § 1.355-2(d)(2).

We think that the time period of one year between the conversion and the distribution would be a sensible benchmark given the way in which such timeframe is considered in other analogous areas of the Code and the regulations. Thus, both section 338 and section 336(e) (and the regulations promulgated thereunder) require that, in order for an acquisition of stock to qualify as a "qualified stock purchase" or a "qualified stock disposition," respectively, stock meeting the requirements of section 1504(a)(2) generally must be acquired during a twelve-month period.[27] Similarly, the regulations governing reorganizations within the meaning of section 368(a)(1)(B) provide as a guidepost that acquisitions of the target corporation is permitted to occur tax-free "in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months."[28]

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

Respectfully submitted,

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27 Section 338(d)(3), Treas. Reg. § 1.336(e)-1(b)(6).
28 Treas. Reg. § 1.368-2(c).

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