NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

April 17, 2009

VIA HAND DELIVERY AND U.S. MAIL

The Honorable Michael Mundaca
Deputy Assistant Secretary (International Tax Affairs)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 3045
Washington, DC 20220

The Honorable Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Room 3000
Washington, DC 20224

Re: Guidance Request With Respect to New Section 108(i)

Gentlemen:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity to offer suggestions for guidance under Section 108(i)[1] which provides an election to defer certain cancellation of debt (COD) income for a number of years, as further described below. NAREIT is the representative voice for U.S. real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

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[1] For purposes of this letter, "Section" refers to the Internal Revenue Code of 1986, as amended (the "Code").

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

EXECUTIVE SUMMARY

The United States is in the midst of the greatest financial crisis in 75 years, a crisis largely caused by the virtual collapse of the debt marketplace. Unemployment is rising, businesses are failing and credit is increasingly difficult to obtain, even for creditworthy borrowers. On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act that includes a provision encouraging companies to deleverage by providing for a deferral of COD income realized in 2009 and 2010. NAREIT strongly encourages the Treasury Department and IRS to interpret this legislation in the manner most likely to allow REITs and other taxpayers considering debt repurchases and other transactions that could result in COD income to utilize fully the tools that Congress has provided so that they may conserve capital, reduce debt, and provide stimulus to the economy during the current crisis.

NAREIT is pleased that the Treasury Department and the Internal Revenue Service (IRS) have indicated at least informally that they plan to issue guidance with respect to certain issues under Section 108(i). NAREIT's specific suggestions for guidance follow and are more fully discussed below.

First, to both remain consistent with Congressional policy to defer certain COD income realized in 2009 and 2010 and longstanding Congressional policy to provide for one level of REIT taxation on distributed earnings, NAREIT requests that the Treasury Department and IRS issue guidance that REIT "earnings and profits" (E&P) are increased when the deferred COD income under Section 108(i) is recognized, not when it is realized. Otherwise REIT shareholders would face double taxation of the COD income under Section 108(i), thereby making this new subsection less attractive to REITs.

Second, debt issued by a pass-through entity should be considered issued "in connection with the conduct of a trade or business" of such entity (and therefore eligible for exclusion under Section 108(i)) so long as the partnership is eligible to claim deductions under section 162. This simple rule would provide clarity for pass-through entities considering the repurchase of outstanding debt or the workout of troubled debt.

Third, transfers of interests or assets that do not result in a "cashing out" of such interests should not be viewed as events causing acceleration of COD income deferred under Section 108(i). Thus, tax-free reorganizations, like kind exchanges, and similar transactions should not give rise to acceleration of deferred COD income.

Fourth, NAREIT recommends that this guidance also clarify that REITs are not considered "pass thru entities" for purposes of Section 108(i)(5)(D)(ii) so that transfers of interests in REITs do not accelerate a REIT's COD income deferred under Section 108(i).

DISCUSSION

I. <u>To Remain Consistent with the Congressional Policy of Deferring COD Income and Taxing REITs Once on Distributed Income at the Shareholder Level, REIT Earnings and Profits Should Increase When COD Income is Recognized, Not When Deferred</u>

A. <u>Background</u>

1. <u>American Recovery and Reinvestment Act of 2009 (the Act): Enactment of Section 108(i)</u>

a. <u>Purposes of Act</u>

Section 3 of the Act states its purposes:

> (a) Statement of Purposes- The purposes of this Act include the following:
>
> (1) To preserve and create jobs and promote economic recovery.
> (2) To assist those most impacted by the recession.
> (3) To provide investments needed to increase economic efficiency by spurring technological advances in science and health.
> (4) To invest in transportation, environmental protection, and other infrastructure that will provide long-term economic benefits.
> (5) To stabilize State and local government budgets, in order to minimize and avoid reductions in essential services and counterproductive state and local tax increases.

The Senate Committee on Appropriations submitted a report for a bill, some of whose provisions were folded into the Act, and noted that:

> All economists agree that the Nation is facing one of the most dire economic crises in our history. Over the past 2 months more than 1 million jobs have been lost. Nothing indicates that similar job losses won't continue unless the Federal Government acts. . . . The country is enmeshed in a grave crisis. It is imperative that the Federal Government use all means at its disposal to address the problems. . . . . With each passing week that the Congress fails to address our economic problems, additional thousands will continue to join the ranks of the unemployed. Inaction will only add to our challenges. This measure is only one step but it is a very important step in addressing this problem.

S. Rep. No. 3, 111th Cong., 1st Sess. at 3-4 (2009).

b. Section 108(i)

Section 1231 of the Act adds new section 108(i) to pre-existing section 108. Section 108(i) allows certain taxpayers to elect to defer certain types of COD income in connection with "applicable debt instruments" realized in 2009 or 2010 until 2014, and the COD income is recognized ratably over the tax years 2014-2018. This provision was designed to "[p]rovide . . . assistance to companies looking to reduce their debt burdens by delaying the tax on businesses that have discharged indebtedness, which will help these companies strengthen their balance sheets and obtain resources to invest in job creation."[2]

An "applicable debt instrument" is defined under Section 108(i)(3)(A) as any debt instrument issued by a C corporation or "any other person in connection with the conduct of a trade or business by such person."

Section 108(i) identifies a number of situations in which COD income deferred under Section 108(i) will be accelerated. Specifically, Section 108(i)(5)(D) provides:

> (i) In general
> In the case of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances, any item of income or deduction which is deferred under this subsection (and has not previously been taken into account) shall be taken into account in the taxable year in which such event occurs (or in the case of a title 11 or similar case, the day before the petition is filed).

Section 108(i)(5)(ii)(D) also provides a special rule for "pass-thru entities:"

> The rule of clause (i) shall also apply in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity.

As an income deferral provision, Section 108(i) operates differently from the pre-existing COD income exclusions under 108(a)(1). Under Section 108(a), gross income specifically excludes COD if the COD income occurs: a) in a Title 11 bankruptcy case; b) when the taxpayer is insolvent; c) when the indebtedness is "qualified farm indebtedness"; and, d) for non-C corporations, when the indebtedness is "qualified real property business indebtedness" (QRPBI). COD income excluded in the first three situations is then applied to reduce various tax attributes in order ending with reduction of the tax basis of the taxpayer's property (although the taxpayer could elect to reduce tax basis of depreciable property first under Section 108(b)(5)). In the case of COD from QRPBI, only tax basis is reduced. However, if the amount of COD income exceeds the amounts of these tax attributes, COD income (other than COD income attributable to QRPBI) is still excluded from the taxpayer's gross income.

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[2] Speaker of the House Nancy Pelosi (D-CA), quoted in http://www.speaker.gov/newsroom/legislation?id=0273.

Section 108(i)(7) also provides authority to the Treasury Department to: "prescribe such regulations, rules, or other guidance as may be necessary or appropriate for purpose of applying [section 108] including "rules for the application of this subsection to partnership, S corporations, and other pass-thru entities. . ."

2. <u>REITs</u>

a. <u>Only One Level of Taxation for Distributed Earnings of Qualified REITs</u>

Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through companies modeled after mutual funds. Just as mutual funds allowed investors to pool their resources to acquire a diversified portfolio of stocks and securities, REITs similarly combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, hotels, shopping centers, offices, timberlands, and warehouses. Just as distributed earnings of mutual funds were subject to a single level of taxation at the shareholder-level, so too would distributed earnings of REITs similarly be subject to shareholder-level only taxation. The House Ways and Means Committee described its reasons for the creation of the REIT provisions as follows:

> The omission of the corporate income tax in the case of distributed earnings, which present law provides for [mutual funds] secures [for mutual fund investors] essentially the same tax treatment as they would have received if they had invested directly in the [stocks and securities owned by the mutual funds]. H.R. 12559 extends this same type of tax treatment to [REITs]. . . . [T]he equality of tax treatment between the beneficiaries of [REIT] and the shareholders of [mutual funds] is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.

H.R. Rep. No. 2020, 86th Cong., 2nd Sess. at 820, 821 (1960).

Just like mutual funds, REITs are required to distribute at least 90% of their taxable income to their shareholders. In exchange for doing so (and for satisfying a number of other requirements to ensure that they are real estate focused), federal law grants REITs a dividends paid deduction (DPD). For example, REITs must satisfy quarterly asset tests (the Asset Tests) and annual income tests (the Income Tests) demonstrating significant real estate assets and income from such assets. Specifically, under Section 857(a), to maintain REIT status, a REIT's DPD generally must equal or exceed 90% of a REIT's REIT taxable income (REITTI) for the year less its capital gains and "excess non-cash income" (described below). Most Securities and Exchange Commission (SEC) registered REITs distribute at least 100% of their taxable income as a dividend annually. As a result, the income and gain of these REITs are generally taxed solely at the shareholder level. To the extent that REITs retain up to 10% of their taxable income, they pay tax at the corporate level on this amount.

b. Umbrella Partnership REITs and Pass-Through Entity Structures: Prevalent Method for U.S. Real Estate Ownership

The majority of listed REITs operate through the umbrella partnership (UPREIT) format in which the publicly traded REIT owns substantially all of its assets and conducts substantially all of its operations through an operating partnership (OP). As a general rule, the REIT will own a number of "common units" in the OP equal to the number of shares of common stock that the REIT has outstanding. In addition, if the REIT has preferred stock outstanding, the REIT will own "preferred units" in the OP that correspond to the shares of preferred stock that the REIT has outstanding.

Typically, the REIT acquires its interest in the OP in one of two ways, both evidencing a substantial equity investment in the OP. First, the REIT may sell its shares in an initial public offering and contribute the cash proceeds to the OP. Alternatively, the REIT may contribute real property or partnership interests in partnerships that own real property to the OP. Then, the REIT (or a subsidiary) typically acts as the sole general partner of the OP, and has the exclusive right to manage the affairs of the OP, subject to limitations intended primarily: 1) to preserve the effective economic identity of interest that exists between the units and the REIT shares; and, 2) to avoid the REIT or OP taking actions that would eliminate or adversely affect the redemption/exchange right for unitholders. Since all employees of the real estate business are typically at the OP level (and below), and because the OP must generate qualifying REIT income and hold qualifying real estate assets, in order for the REIT to preserve its tax status, the OP essentially conducts the business of the REIT as if it were a REIT.

Furthermore, just like other real estate owners, REITs and their OPs also invest in real estate through joint venture limited partnerships or limited liability companies (LLCs) with third parties. The limited partnership (and now the LLC) is and has been for decades the prevalent method for owning real estate in the U.S.

c. COD Income and the REIT Rules

The current economic crisis, and particularly the freeze in the credit markets, has highlighted for Congress the benefit of encouraging companies to reduce debt. Section 108(i) is one way that Congress has provided to achieve this goal. As further described below, if REIT E&P were to be increased immediately on realization of COD, this Congressional goal would be thwarted. Similarly, the Congressional goal of single taxation on income distributed by a REIT would be compromised. Since Congress has not spoken on the effect to E&P of the deferral of COD under Section 108(i), and particularly since Section 312(l) does not specifically state that E&P is immediately increased as a result of the deferral of COD income, the Treasury Department and IRS should direct taxpayers to calculate E&P as a result of COD deferral under 108(i) in a way that fosters the Congressional policy of reducing leverage, consistent with the taxpayer's method of accounting for deferred COD income in calculating taxable income.

The Code contains a number of REIT-specific provisions relating to COD income. First, Section 108(e)(9) provides that COD income is not taken into account under the Income Tests. Second, COD income is among the items considered in the calculation of "excess non-cash income" under Section 857(e). The calculation of excess non-cash income under Section 857(e) is actually the sum of certain specified types of "non-cash" income, including COD income, less 5% of REIT taxable income (determined without regard to the DPD and by excluding any net capital gain). Thus, the excess of non-cash income over 5% of the REIT's taxable income does not have to be distributed in order to maintain REIT qualification.

While REITs are not required to distribute most COD income to satisfy the 90% distribution requirement, they must pay corporate-level tax on any COD income they retain. Additionally, REITs are subject to a 4% excise tax under Section 4981 to the extent that they do not distribute annually the sum of at least 85% of their "REIT ordinary income" and 95% of their capital gain net income for the year. As relevant here, "REIT ordinary income" is basically a REIT's "REIT taxable income" as defined in Section 857(b)(2).

3. <u>Calculation of E&P: Follows "Method of Accounting" for Computing Taxable Income</u>

a. <u>To Qualify for the DPD, REIT Distributions Must Be Attributable to Current or Accumulated E&P</u>

For a REIT's distribution to be considered a "dividend," and therefore eligible for the DPD, it must be either attributable to current or accumulated "earnings and profits" of the REIT. Section 316(a). E&P is a tax term that is not completely defined in the Code.

b. <u>Calculation of E&P Follows Method of Accounting for Calculating Taxable Income</u>

Section 312 provides the general rules concerning the calculation of E&P, but it does not provide an actual formula for calculating E&P. Instead, Treas. Reg. § 1.312-6 describes the general rules for calculating E&P. Specifically, it provides that "the amount of [E&P] will be dependent upon the method of accounting properly employed in computing taxable income." According to Treas. Reg. § 1.446-1(a)(1), the term "method of accounting" includes not only the overall method of accounting of the taxpayer, but also the accounting treatment of any item. Treas. Reg. § 1.312-6(b) further provides that:

> [a]mong the items entering into the computation of [E&P] for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts. ….

Section 312(f)(1) also addresses the effect on E&P of non-recognition transactions, which are essentially transactions in which gain or loss might be realized but their recognition is deferred. Section 312(f)(1) generally provides that gain or loss on the sale of property affects E&P in the year recognized, not in the year of the non-recognition transaction.

In contrast to excluded income (*e.g.*, tax exempt interest) that increases E&P when realized, deferred income should not increase E&P until it is recognized for federal income tax purposes absent an express statutory provision to the contrary. For example, in Rev. Proc. 2004-34, 2004-1 C.B. 991, the IRS provided a procedure whereby certain taxpayers could defer inclusion in gross income of certain "advance payments" received in one taxable year until the following taxable year. In PLR 200817029, the IRS held that a taxpayer "need not make any adjustment in computing its earnings and profits under Section 312 of the Code for advance payments properly deferred under Rev. Proc. 2004-34, 2004-1 C.B. 991. Treas. Reg. § 1.312-6(a); *see* Rev. Rul. 79-68, 1979-1 C.B. 133."

In Rev. Rul. 79-68, the IRS had held that a taxpayer was not required to make any adjustment in computing its E&P under section 312 of the Internal Revenue Code of 1954 for the amount of income deferred under Rev. Proc. 71-21, 1971-2 C.B. 549 (*modified and superseded by* Rev. Proc. 2004-34). The IRS stated that "[t]he use of the specialized method of accounting prescribed in Rev. Proc. 71-21 for reporting advance payments for services does not give rise to any adjustments in computing earnings and profits." PLR 200817029 thus confirms that income deferred does not increase E&P in the year of the deferral, but rather when recognized.

As further described below, the statutory provisions of Section 312 contain several exceptions to the general rule that timing of E&P follows the timing of taxable income recognition. The existence of these specific exceptions indicate that, absent a specific statutory exception, the calculation of E&P should follow the general rule of following the method of accounting for income taxes.

One statutory exception, for example, is in Section 312(n)(5), which provides that "[i]n the case of any installment sale, E&P is calculated as though corporation were not on the installment method."

Similarly, Section 312(l) contains a provision relating to the calculation of E&P in connection with COD income applied to reduce basis under Section 1017. In such a case, E&P does not include COD income to the extent of the amount applied to reduce basis under Sections 108(b) and 1017. The policy for this rule (which had been adopted by the courts prior to the enactment of Section 312(l)) is that, because the excluded COD income eventually will be taxed to the taxpayer through a reduction in future depreciation deductions and/or increased gain (or decreased loss) on sale, it is appropriate to delay the E&P effect until those tax detriments actually effect taxable income. This policy is also consistent with the policy behind Section 312(f)(1) of deferring the E&P effect of non-recognition transactions until the unrealized gain or loss is later recognized for income tax purposes. We believe a similar policy is called for in the context of taxable COD income deferred under Section 108(i).

We note that Section 312(l) does not indicate how E&P is affected by excluded COD income that is not applied to reduce basis under Section 1017. It appears that such COD income would increase E&P when the debt cancellation occurs. However, while current E&P inclusion may be appropriate for COD income that is permanently excluded from taxable income without a corresponding reduction in the basis of the taxpayer's property, we believe that this rule should not apply when the COD income is merely deferred under Section 108(i) and will not be eligible for exclusion or give rise to attribute reduction when recognized.

c. Specific Rules for Calculating REIT E&P

In addition to the general rules for taxpayers calculating E&P under Section 312, there are a number of provisions specifically applicable to the calculation of REIT E&P. For example, under Section 857(d)(1), a REIT's current (but not accumulated) E&P is not reduced by any amount not "allowable" in computing REIT taxable income (*e.g.*, capital losses not deductible in computing taxable income). Furthermore, under Section 857(d)(2), a REIT is deemed to have enough E&P to support treatment of a distribution as a dividend but only to the extent necessary to meet the minimum distribution for the excise tax (85% of ordinary income). Presumably, this provision allows the REIT to be viewed as having that amount of E&P also for purposes of determining whether a distribution to shareholders qualifies for the DPD at least up to the amount to meet the minimum distribution for excise tax purposes.[3]

B. If E&P is Increased in The Year of COD Deferral, Immediate and Double Taxation of Deferred COD Income Could Result

As noted above, REITs are required to distribute at least 90% of their REIT taxable income. While REITs do their best to estimate the required distribution, for a variety of reasons, they may distribute in excess of 100% of taxable income. For example, shareholders may expect a certain regular distribution. Furthermore, since REIT taxable income is reduced by depreciation, a non-cash expense, REITs may have cash in excess of taxable income on hand and may distribute such cash to shareholders.

The following example (simplified for the purposes of illustration) illustrates the potential double taxation of deferred COD income under Section 108(i) if such income were to increase E&P in the year of the debt cancellation. In 2009, assume REIT A has $100 in REITTI and E&P other than any COD income and decides to distribute $120 in 2009 (without the COD income, the shareholders would have $100 in ordinary dividend income and $20 in return of capital). In 2009, REIT A does a debt for debt exchange that generates $20 in COD income and it elects to defer such income under Section 108(i) to defer recognition of that COD. If REIT A's E&P increases by the amount of COD income deferred by Section 108(i), in 2009 its shareholders would recognize $120 as ordinary income instead of $100.

[3] Thus, if a REIT needed to distribute $100 to eliminate its taxable income, but only $85 to eliminate its excise tax liability, it would be deemed to have up to $85 of E&P. However, since it would have a $15 shortfall in E&P, it still could face tax liability on the $15 difference between the distribution necessary to eliminate taxable income and the distribution necessary to eliminate excise tax liability.

Fast forward to 2014. Assume REIT A has $100 in REITTI and E&P and decides to distribute $100, which without regard to the COD income would produce $100 in ordinary income to its shareholders. Section 108(i) requires REIT A to recognize $4 of deferred income in 2014 (20% x $20). REIT A's REITTI is now $104, so it now has the choice of paying corporate tax on $4 or distributing $104 so that its DPD covers its REITTI. However, since REIT A only has $100 of E&P — the deferred COD of $4 already increased E&P and was distributed in 2009 — the REIT apparently cannot eliminate the $4 of COD income with a DPD. As a result, REIT A will be subject to tax on this $4 of COD income in 2014 even though REIT A's shareholders had been subject to tax on such income in 2009.

On the other hand, if the deferred COD income of $20 does not affect E&P until it is recognized, the tax consequences are much more rational. In 2009, REIT A’s shareholders have $100 of ordinary income and $20 of return of capital. In 2014, when REIT A has $104 of income, it also has $104 of E&P. If it distributes at least $104, it will have no REITTI, and its shareholders will be taxed on the $104 distribution.

In sum, immediate increase of REIT E&P as a result of COD deferred under Section 108(i) would contravene two Congressional goals: the goal of deferring qualified COD income realized in 2009 and 2010 as a means of helping companies deleverage and improve their balance sheets and the goal of subjecting distributed REIT income to a single level of taxation at the shareholder level. To avoid contravening these goals, we strongly urge the Treasury Department and IRS to conclude that a REIT’s E&P be adjusted for COD income deferred under Section 108(i) only as and when the REIT includes such amount in taxable income, consistent with the general theme of the Section 312 rules to coordinate timing of E&P adjustment with taxable income recognition.

II. <u>Debt Issued By a Pass-Through Entity That Claims Business Expenses Under Section 162 Should Be Considered Issued “In Connection with the Conduct of Its Trade or Business”</u>

Section 108(i) provides for deferral for COD only from “applicable debt instruments.” Section 108(i)(3)(A)(i) defines “an applicable debt instrument” as a debt instrument issued by a C corporation. Section 108(i)(3)(A)(ii) defines an “applicable debt instrument” as one issued by a any person other than a C corporation “in connection with the conduct of a trade or business” by such person. As noted earlier, the majority of publicly traded REITs conduct all of their business through an OP which owns qualifying REIT assets and generates qualifying REIT income. Of course, these operating partnerships are carrying on a trade or business and claiming ordinary and necessary business deductions under Section 162.

It would not be sensible, nor consistent with the intent and purpose of the statute, if a REIT could defer COD with respect to a debt instrument issued at the REIT level, but if that same debt instrument had been issued at the REIT’s OP, the OP could not defer COD with respect to such debt instrument. However, the application of Section 108(i)(3)(A)(ii) concerning debt issued by a non-C corporation is unclear. To provide greater certainty along with a simple, bright line test, we propose that the requirement in Section 108(i)(3)(A)(ii) of having debt be issued in connection with the conduct of a trade or business be satisfied if a partnership that issued debt is eligible to claim business expenses under Section 162. *Cf.* Fegan v. Commissioner, 71 T.C. 791, 814 (1979), *aff'd*, 81-1 U.S.T.C. ¶ 9436 (10th Cir. 1981); Post v. Commissioner, 26 T.C. 1055 (1956), *acq.*, 1958-1 C.B. 5; Hazard v. Commissioner, 7 T.C. 372 (1946), *acq*. 1946-2 C.B. 3.[4]

III. <u>Transfer of Interests That Do Not Result in "Cashing Out" a Transferor's Interest Should Not Accelerate Deferred COD</u>

Section 108(i)(5)(D) provides that the following will cause an acceleration of COD deferred under Section 108:

> [T]he death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances, any item of income or deduction which is deferred under this subsection (and has not previously been taken into account) shall be taken into account in the taxable year in which such event occurs (or in the case of a title 11 or similar case, the day before the petition is filed).

Section 108(i)(5)(D)(ii) provides the following rule concerning "pass-thru entities:"

> The rule of clause (i) shall also apply in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity.

The statute does not clearly define which situations include a "cessation of business." For example, non-recognition transactions that involve a carry over of tax attributes under Section 381 should not be considered acceleration events because they do not involve a true cessation of business.[5] Specifically, to qualify for non-recognition treatment, they involve some type of continuity of business activities and interest.

Examples of such transactions include reorganizations that qualify under Section 368(a) and like kind exchanges under Section 1031. Transactions that result in a technical termination of a partnership under Section 708(b)(1)(B) similarly should not give rise to acceleration of COD income at the partnership level because they have already given rise to acceleration of COD at partner level with respect to those partners that have transferred their partnership interests.

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[4] Historically, the phrase "in connection with the conduct of a trade or business" has been interpreted broadly. *See* Snow v. Commissioner, 416 U.S. 500 (1974)(experimental expenses held deductible even though not rising to the level of a Section 162 trade or business). We assume that depreciable rental real estate, including real property that is leased on a "triple net lease" basis qualifies for the trade or business requirement of Section 108(i).

[5] *See, e.g.*, Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05) May 2005 at 387, fn. 734, in connection with a provision eliminating partnership built-in losses upon the transfer or liquidation of the contributing partner's partnership interest, noting that such losses are not eliminated upon a transfer of an interest if Section 381 applies: "[i]t is intended that a corporation succeeding to attributes of the contributing corporate partner under Section 381 shall be treated in the same manner as the contributing partner."

Nor does the statute clearly define a sale or exchange (as used in Section 108(i)(5)(D)(ii)). Absent guidance, the sale or exchange language could be interpreted too expansively, in which case the Congressional goal of deferring qualified COD income realized would be thwarted. For example, Section 708(b)(1)(B) uses identical language (but for a much different purpose), and in that context a sale or exchange includes Section 351 and 721 contributions of interests, deemed transfers that result from a Section 708(b)(1)(B) termination of an upper tier partnership, and mergers and other reorganizations involving corporate partners. To comply with the stated goal of Congress, a sale or exchange for purposes of Section 108(i)(5)(D)(ii) should be limited to transfers or exchanges where the partner has cashed out, and should exclude those where it has simply altered the way in such interest is held.

As a result, we propose that guidance be issued limiting acceleration events to those events involving a true cessation of business as a result of a cash out of the transferor's interest. At a minimum, we propose excluding the following transactions from the definition of events that would cause acceleration of deferred COD: 1) reorganizations under Section 368(a); 2) transfers under Section 351; 3) like kind exchanges under Section 1031; 4) partnership mergers in which the acquired partnership's business is continued; and, 5) technical partnership terminations under Section 708(b)(1)(B). Similarly, guidance should be issued limiting acceleration events to those events involving a sale or exchange of interests in a pass-thru entity which result in a cash out of the transferor's interest.

Furthermore, it would be helpful to clarify that a "cash out" transfer of "an" interest in a pass-thru entity only results in acceleration of deferred COD income for that transferor, rather than for the entire pass-thru entity (and all of the other holders of interests in the pass-thru entity). [6]

IV. REITs Are Not Pass-Thru Entities Under Section 108(i); Thus, Transfers of REIT Interests Should Not Accelerate COD Deferred Under Section 108(i)(5)

Section 108(i)(5)(B)(iii) provides that "in the case of a of a partnership, S corporation, or other pass-thru entity, the election under [section 108(i)] shall be made by the partnership, the S corporation, or other entity involved." Furthermore, Section 108(i)(5)(D)(ii) applies special rules to the transfers of interests in "pass-thru entities" the result of which could cause acceleration of COD deferred under section 108(i) for such pass-thru entity. However, Section 108(i) does not specifically define the term "pass-thru entity."

It is important to clarify that REITs are not pass-thru entities for these purposes such that a transfer of an interest in a REIT would cause acceleration of the REIT's deferred COD. This

[6] We assume that the acceleration provision of Section 108(i)(5)(D)(ii) means that the transfer of any interest in the pass-thru entity that elected COD deferral under Section 108(i) would accelerate the COD deferred with respect to that transferor or transferors, not with respect to the entire pass-thru entity. Thus, for example, a 1% partner's transfer of his entire interest in a partnership that deferred COD under 108(i) could result in acceleration of such partner's deferred COD income, not in ALL of the partners' deferred COD income. However, it would be helpful to clarify this point in regulatory guidance.

would have the absurd effect of accelerating COD deferral if a single share of a listed REIT that had made the Section 108(i) election is sold on the New York Stock Exchange.

First, a REIT by definition is required to be taxable as a domestic corporation. Further, Section 1361(a)(2) states that "[f]or purposes of this title" the term "C corporation" is defined as a corporation that is not an S corporation. Thus, REITs are C corporations for all purposes of the Code unless a Code section otherwise expressly provides. As you know, widely held C corporations rarely are considered pass-thru entities for federal income tax purposes because they cannot pass through losses to their shareholders. In fact, we are not aware of any IRS guidance holding that a REIT is a pass-thru entity in the absence of express statutory direction. As a result, NAREIT recommends that the Treasury Department and IRS issue guidance clarifying that REITs are not pass-thru entities under Section 108(i).

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Thank you for your consideration of this matter. Feel free to contact me or Dara Bernstein, NAREIT's Senior Tax Counsel, at (202) 739-9400 if you would like to discuss these issues in greater detail.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

cc: Eric A. San Juan, Esq.
Jeffrey Van Hove, Esq.
Steven G. Frost, Esq.
David H. Shapiro, Esq.
Michael S. Novey, Esq.
Donald W. Bakke, Esq.
Clarissa C. Potter, Esq.
George J. Blaine, Esq.
Stephen R. Larson, Esq.
Craig Wojay, Esq.
Deborah Clark, Esq.