The Real Estate Roundtable

February 21, 2018

The Honorable Steven T. Mnuchin
Secretary of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Mnuchin:

Thank you again for the critical role you played in passing tax reform, as well as your thoughtful approach toward its implementation. Following up on my January 18 letter identifying several areas where early guidance could reduce the potential for economic disruption, The Real Estate Roundtable respectfully requests that Treasury guidance clarify important aspects of the real property trade or business election under the new interest limitation rules at the earliest possible time.

In particular, we respectfully urge the Treasury to clarify that interest (other than investment interest) on debt incurred by an owner of an entity engaged in a real property trade or business, that can be properly traced to the owner's investment of funds in that real property trade or business, will be treated as interest that is allocable to that real property trade or business, and therefore exempt from the new business interest limitations, if that real property trade or business has made (or is treated as having made) an election out of the new interest limitation rule.

The remainder of this letter explains the business and policy rationale, as well as the technical support, for such a conclusion.

Common Ownership Structures for Real Estate Investment

Real estate investments are often developed, purchased, or owned by multiple parties. In some cases, this necessitates using more than one entity, and often necessitates a tiered structure in which different investors fund the ultimate hard investment costs by investing through different entities and at different levels in a tiered structure. For example, a corporation and a partnership may each borrow money to fund their separate investments in another partnership or a REIT (the lower-tier entity) that will be making the ultimate investment in the real estate. Thus, that ultimate investment will be made by that lower-tier entity using a combination of its own money, money it has borrowed directly, and money it received as an investment from the aforementioned corporation and partnership which those entities obtained through their own borrowings. In such a case, it should not matter whether the debt that is funding the ultimate real estate investment is borrowed directly by the lower-tier entity, or is borrowed by an upper-tier investor.

Other examples of common scenarios where the financing of a real property trade or business occurs through a tiered structure would include the following:

(i) Developer Corp and U.S. tax-exempt investor agree to form a 50-50 joint venture for the purpose of developing an office building. Developer obtains its 50% cash contribution to the equity of the joint venture by borrowing money, possibly secured by a different real estate investment owned by Developer. The lower-tier joint venture does not incur the debt directly and the U.S. tax-exempt investor does not incur any debt.

(ii) Real estate fund projects a 10% return for its equity investors. The fund itself may have its own debt. Individual passive investor has the ability to borrow at a rate of 5%. Thus, the passive investor borrows his own equity contribution from an unrelated lender at a 5% interest rate to make an equity investment he anticipates will yield 10%.

(iii) Public REIT operates through an umbrella partnership (UPREIT) structure[1] where all of its assets are held in a lower-tier operating partnership. The operating partnership in turn owns some of its assets through lower-tier joint venture partnerships or other REITs. The operating partnership borrows in the public debt markets and invests the proceeds to acquire or capitalize an interest in one or more joint venture partnerships or REITs.

(iv) Public REIT owns real estate assets through LLC holding companies ("SPEs") owned by one or more subsidiary REITs ("Sub REITs") or an UPREIT. REIT, Sub REIT, UPREIT or SPE borrows in the public debt markets to enable the SPEs to buy the real estate investments. Investor that is a REIT or a C corporation borrows to acquire an interest in the REIT (or to acquire an interest in an UPREIT owned by the REIT or to acquire an interest in a real estate limited partnership that has acquired the interest in the UPREIT or REIT).

Applying the Real Property Trade or Business Election to Common Ownership Arrangements

We are not aware of any policy reason why interest on debt incurred by an owner, to fund an investment in a partnership or other entity engaged in a real property trade or business, would not be properly viewed and treated as interest on debt allocable to that trade or business. Out of an abundance of caution—because the new interest limitation rules could have draconian effects on property values and the healthy functioning of real estate markets—it would be very helpful to clarify that this principle applies for purposes of the real property trade or business exception from the new interest limitation rules.

In general, the operative provisions of Section 163(j) speak of interest that is "properly allocable" to a trade or business. Use of the phrase "properly allocable" is consistent with a legislative recognition that a reasonable allocation method must be applied, which would clearly extend to both directly and indirectly held businesses. Treating the interest expense at an upper tier entity as "properly allocable" to the real property trade or business of the lower-tier entity when the funds are traceable to an interest in the lower-tier entity and the lower-tier entity is engaged in a real property trade or business is consistent with the intent of the provision, and conforms with rules and principles found in other guidance provided by the IRS when appropriate. For example, Notice 89-35 provides that interest expense of a partner or shareholder can be

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

traced to the activities of a partnership or an S corporation and Notice 97-64 effectively requires the classification of a REIT shareholder's dividends to be calculated based on the manner in which it would have been calculated if the REIT was an individual.[2]

In this manner, with the exception of amounts treated as investment interest under section 163(d), the real estate exception should extend to debt incurred to acquire interests in, or capitalize, entities that are engaged in a real property trade or business, including the examples noted above. Because REITs are such an important part of the real estate business and essentially apply flow-through treatment to their net income and gains, this principle should apply to investments in REITs as well as investments in partnerships.

Early Treasury guidance confirming this interpretation would avoid potential economic disruption. Given that Section 163(j) is applicable as of January 1, 2018 and that upper-tier entities are common and typically driven by business needs and practicalities, we respectfully request expedient guidance that taxpayers may treat interest expense as "properly allocable to" a real property trade or business when the interest is properly allocable (through one or more tiers of entities) to an entity that is in a real property trade or business.

Corporate Borrowers Investing In Corporations or REITs)

One technical issue in particular is presented, to our understanding, for the first time. Under prior law, corporate interest (which would include interest on debt held by a REIT) was generally deductible. Thus, it made no difference that all corporate interest was considered "business" interest and not "investment" interest. Congress intended to preserve that rule. However, if corporations (including REITs) are to continue to invest – as many do today – in other corporations (including REITs) that are engaged in real estate businesses, a concept must be applied to treat the investing corporation's interest as "properly allocable to" the real estate business of the REIT or corporation carrying on that business. That is, just as corporate interest incurred to invest in another corporation (or REIT) is mandatorily treated as interest "allocable to a trade or business" if the investee corporation (or REIT) is engaged in a real estate trade or business, the corporate interest of the investing corporation should be treated as properly allocable to a *real estate* trade or business carried on by the investee corporation (or REIT). Thus, if the election has been made (or is otherwise applicable to) that business, the investing corporation's interest should be exempt from the interest disallowance rules.

Congressional tax-writers considered a rule that would have exempted debt incurred by pass-through businesses from the business interest limitation. Some expressed concern, however, that taxpayers would use a broad exemption for pass-through debt to inappropriately shift corporate debt to related, non-corporate entities. Ultimately, rather than a rule based on the legal form of the borrower, Congress opted for a rule that applies to all types of taxpayers—corporations, partnerships, sole proprietors, etc.—but exempts debt allocable to certain trades or businesses. In so doing, Congress expressly "recognize[d] that certain types of trades or businesses have particular characteristics that warrant special rules related to interest deductibility." H. Rpt. 105-409 at 248 (Nov. 13, 2017). Applying the real property trade or business exception to debt incurred by a corporate borrower and invested in a lower-tier corporation or

[2] In addition, certain statutory provisions explicitly provide that the activities of a REIT are effectively attributed to a shareholder. For example, Section 897(h) of the Code treats a shareholder as having gain from the sale of a United States real property interest to the extent the distribution is attributable to the disposition of a United States real property interest by the REIT. For purposes of the 75 percent "good REIT income" test, Section 856(c)(3)(D) treats dividends and capital gains from another REIT as real estate income earned by the shareholder REIT.

REIT that is engaged in a real property trade or business is consistent with the intent, spirit, and structure of the new business interest limitation regime, which focuses on the actual trade or business to which the borrowed funds are allocated.

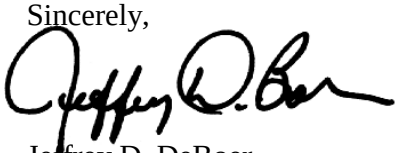
Allocating Indebtedness within Entities

In addition, we also believe it would be helpful to provide guidance to determine how indebtedness would be allocated among different activities of a taxpayer. The most relevant existing precedent is set forth in Treasury Regulation Section 1.163-8T, as expanded upon in Notice 89-35 (which modified prior Notices 88-20 and 88-37). As noted above, these Section 163 regulations apply the same "properly allocable" standard already used for Section 469 purposes (which we note is the source of the definition of real estate trades or businesses eligible for the election). Further, the Treasury Regulation Section 1.163-8T rules have a direct tracing mechanism that would address the added complexity if the upper-tier entity had more than one lower-tier investment.[3] We respectfully request that the Treasury guidance apply the tracing rules under Treasury Regulation Section 1.163-8T, as expanded upon in Notice 89-35 (which modified prior Notices 88-20 and 88-37), in determining interest expense that is allocable to a real property trade or business. The Preamble to Treasury Regulation Section 1.163-8T indicates that Treasury and the IRS carefully considered competing methodologies to apply the "properly allocable" standard, including a pro rata allocation methodology. These competing methodologies were rejected after lengthy policy deliberations for reasons that are set forth in the Preamble.

* * *

The Real Estate Roundtable is appreciative of your deliberate approach to tax reform and its implementation. We are grateful for the open dialogue on these issues with you and your staff. Deputy Assistant Secretary Dana Trier recently addressed The Roundtable's Tax Policy Advisory Committee and engaged in an informative discussion on the rulemaking issues. We look forward to continuing to work with you to accelerate economic growth, create jobs, and improve local communities.

Sincerely,



Jeffrey D. DeBoer
President and Chief Executive Officer

cc: The Honorable Kevin Brady, Chairman, House Committee on Ways and Means
The Honorable Orrin G. Hatch, Chairman, Senate Committee on Finance
The Honorable Richard E. Neal, Ranking Member, House Committee on Ways and Means
The Honorable Ron Wyden, Ranking Member, Senate Committee on Finance

[3] If the upper-tier entity invested only a portion of the financing proceeds into a lower-tier real property business and the remaining proceeds in a non real property business, Treasury Regulation Section 1.163-8T already includes a mechanic to divide the interest expense between the real property and non-real property businesses.