September 4, 2018

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Room 5203
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

To Whom It May Concern:

We are writing on behalf of the members of the National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA) who represent the $1.3 trillion apartment industry and its nearly 39 million residents. We would like to take this opportunity to congratulate the Administration on proposing thoughtful regulations regarding the 20 percent pass-through deduction that we believe holds great promise for spurring investment in multifamily real estate, generating economic growth, and fostering job creation.

As multifamily housing firms now begin to implement the new IRC Section 199A regulations, we want to draw your attention to a few areas within the proposed regulations regarding the calculation of unadjusted basis immediately after acquisition (UBIA), qualifying REIT dividends, and methods of aggregation that we ask the Treasury Department and Internal Revenue Service to revisit prior to issuing final regulations. We request these clarifications so that our industry can build the 4.6 million new apartment units our nation needs by 2030. If these issues are left unaddressed, we are concerned that capital could sit on the sidelines and not be fully deployed.

Calculation of Unadjusted Basis Immediately After Acquisition (UBIA)

NMHC/NAA have concerns regarding the determination of UBIA under the proposed regulations with respect to certain types of transactions commonly used in the real estate industry. These transactions are like-kind exchanges, conversions of sole proprietorships to S Corporations, and acquisitions of partnership interests with IRC Section 743(b) basis adjustments. We ask that the Treasury Department and Internal Revenue Service allow full UBIA to be granted as part of final regulations. Each of these issues is discussed in detail below.

Our guiding principles for purposes of determining UBIA following these transactions are that: (1) the treatment of UBIA should be determined consistent with the treatment provided by Congress for the underlying transaction, and (2) a taxpayer should be no better or worse off with respect to UBIA as a result of engaging in these transactions or engaging in an alternative transaction (in other words, UBIA should be neither lost nor artificially inflated).

Proposed Regulations Limit UBIA Following Like-Kind Exchanges

IRC Section 199A(h)(2) provides Treasury with specific authority to determine the UBIA of property acquired in a like-kind exchange. Treas. prop. reg. sec. 1.199A-2(c)(3) provides that UBIA is the basis on the placed-in-service date of the property as determined under IRC Section 1012 or other applicable provisions. It is unclear how this rule applies to replacement property following a like-kind exchange. However, Example 2 of Treas. prop. reg. sec. 1.199A-2(c)(4) clarifies that the UBIA of the replacement property acquired in a like-kind exchange will be the adjusted basis of the relinquished property, and

the depreciable period for IRC Section 199A purposes begins when the relinquished property was placed in service.[1] In other words, the general rule is to provide the taxpayer with the worst of both worlds; the taxpayer takes a reduced basis in the replacement property (relative to the UBIA in the relinquished property) yet has the shorter remaining depreciable period attributable to the relinquished property.

We believe the proposed regulations do not reach the appropriate legal, tax policy, and economic policy results. First, we acknowledge that Congress provided Treasury with the authority to determine the UBIA of replacement property. However, we do not believe Congress intended the somewhat simplistic rule provided by the proposed regulations, that is, that the property takes whatever basis it normally would have on the date it was placed in service by the acquiring taxpayer (the adjusted basis in the relinquished property). Had Congress intended this simple rule, it would have provided it directly, as it did for property acquired by purchase. Instead, Congress left the determination to Treasury, suggesting that it intended a result different than the general rule applicable to purchased property.

Our view is that Congress intended for Treasury to provide a UBIA rule that is consistent with Congress' overall treatment of like-kind exchanges. Congress provided nonrecognition treatment for like-kind exchanges transactions on the theory that the taxpayer's economic position has not changed as a result of the transaction. Consistent with this theory, Congress requires substituted or carryover exchanged basis with respect to property involved in the transaction.[2] In other words, Congress provided that the replacement property should "step into the shoes" of the relinquished property. To achieve this result, the UBIA of the replacement property should be the UBIA of the relinquished property, not the adjusted basis of the relinquished property. This rule should not impose an administrative burden for an exchanging taxpayer who presumably already knows the UBIA of the relinquished property. The proposed regulations adopt the "stepped in the shoes" rule for purposes of determining the depreciable period under IRC Section 199A. For the sake of consistency, they should do the same regarding the amount of UBIA.

From a tax policy perspective, a taxpayer should be no better or worse off with respect to UBIA as a result of engaging in a nonrecognition transaction. The rule in the proposed regulation does not pass this test, as taxpayers will always have a lower UBIA for replacement property under the proposed regulation than they had in depreciable relinquished property.

The proposed rule will discourage like-kind exchanges because a taxpayer will have a greater amount of UBIA by simply retaining the otherwise relinquished property. This will reduce the velocity of real estate transactions and amount of aggregate investment in the multifamily sector. Like-kind exchanges play a crucial role in supporting the multifamily sector by encouraging investors to remain invested in real estate while still allowing them to balance their investments to shift resources to more productive properties, change geographic location, or diversify or consolidate holdings. The proposed UBIA rules would deter property owners from selling assets in need of capital investment. Taxpayers engaging in like-kind exchanges remain fully invested in real estate and should not be negatively impacted when they reallocate a portfolio. Effective like-kind exchange rules would allow those owners to transfer the property to new owners who can invest the necessary capital to revitalize the asset.

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[1] Unless the taxpayer makes an election under Treas. reg. sec. 1.168(i)-6(i)(1) to re-start recovery period for the replacement property on the date it is placed in service by the taxpayer.

[2] Specifically, IRC Section 1031(d) provides that the "basis" of a replacement property is the "basis" of the relinquished property (adjusted for money received and recognized gain or loss). After the *Tax Cuts and Jobs Act,* depreciable property will have two "bases" – UBIA for purposes of IRC Section 199A(b)(2)(B)(ii) and adjusted basis for all other relevant Code sections. Following a like-kind exchange, the replacement property should take the two bases (UBIA and adjusted basis) of the relinquished property as its own two bases.

NMHC/NAA ask that the Treasury Department and Internal Revenue Service reassess this issue and provide in final regulations that the UBIA of a property acquired pursuant to a like-kind exchange should be equal to the UBIA of the relinquished property.

NMHC/NAA believe that prop. Treas. reg. sec. 1.199A-2(c)(3)(B) achieves the correct result with respect to the excess basis of property acquired in a like-kind exchange, and that prop. Treas. reg. sec. 1.199A-2(c)(3)(C) provides the appropriate rule for taxpayers making an election under Treas. reg. sec. 1.168(i)-6(i)(1).

Proposed Regulations Limit UBIA Following Sole Proprietorship Conversion to S Corporation

The proposed regulations also deny full UBIA with regard to a sole proprietorship converting to a S corporation. Instead of enabling a S corporation to retain the sole proprietorship's UBIA for qualified property for purposes of IRC Section 199A, they allow only the adjusted tax basis of qualified property at the time of conversion to be taken into account. Moreover, the date the property is placed in service by the sole proprietorship remains in effect for purposes of calculating the number of years the qualified property may qualify for IRC Section 199A deduction purposes. The preamble to the proposed regulations does not explain why this result is compelled under the statute or achieves the correct policy result.

Our analysis of the appropriate UBIA treatment upon the conversion of a sole proprietorship into an S corporation is similar to our analysis of like-kind exchanges discussed above. That is, the UBIA treatment should be consistent with the underlying transaction. Congress generally provided that the incorporation of a sole proprietorship is a nonrecognition transaction under IRC Section 351, and the corporation takes a basis in any transferred property equal to the transferee's basis in the property. Thus, we believe that an S corporation should have the same UBIA in property as that of the contributing shareholder.

We can find no authority that supports the position of the proposed regulations. IRC Section 362(a) provides that "If property was acquired by a corporation in a transaction to which section 351 applies…then the basis shall be the same as it would be in the hands of the transferor…" Consistent with our reading of IRC Section 1031(d), we believe the reference to "basis" should refer to both adjusted basis and UBIA such that the corporation should take the same adjusted basis and UBIA, respectively, as that of the transferring shareholder.[3]

Nonrecognition treatment is premised on the theory that the corporation is the alter ego of the contributing shareholder. This is particularly true for S corporations. According to IRS statistics,[4] in 2013 (the last year for which data was made publicly available) there were approximately 4.25 million subchapter S corporations. Of these corporations, more than 90 percent had only one or two shareholders, suggesting that these entities were essentially sole proprietorships with one owner or with married owners. Because an S corporation is a flow-through entity, the tax treatment of its shareholders should be the same as that of the former unincorporated sole proprietors.

Reducing the amount of UBIA of the property held by the S corporation discourages legitimate reorganizations of business activity, including a growing sole proprietorship seeking additional

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[3] Without further belaboring the point, we believe similar treatment should apply to tax-free contributions of property to partnerships.
[4] See, SOI Tax Stats, Corporation Data by Type of Income, Table 6. S Corporation Returns: Total Receipts and Deductions, Portfolio Income, Rental income and Total Net Income by Number of Shareholders Tax Year 2013

investment dollars through converting into a S corporation. If Treasury believes that the use of an S corporation (or partnership) presents an opportunity for abuse, the final regulations should limit UBIA to those specific cases.

We see little reason to discourage investment and job-creating transactions and ask that the final regulations enable the S corporation to benefit from full UBIA following a conversion from a sole proprietorship.

Proposed Regulations Limit UBIA Following IRC Section 743(b) Transactions

Under current law, IRC Section 743(b) enables a new partner in a partnership to receive a stepped-up basis in partnership property so long as an IRC Section 754 election is made. This stepped-up basis rule enables a new partner to avoid disparities between inside and outside basis in that new partner's share of the partnership.

Unfortunately, the proposed regulations deny IRC Section 743(b) basis adjustments for UBIA purposes. In other words, the new partners would only be credited with the UBIA of the old partners. We see little reason for which new partners purchasing an interest in an existing partnership should be treated differently than persons who acquire an undivided interest in the partnership property.

The proposed rule might have negative consequences for the multifamily industry as it could make purchasing multifamily partnership interests less attractive relative to other investments where qualifying basis and resulting taxes could be lower. This, in turn, may have the effect of making partnership interests less liquid and reduce the value of enterprises.

The preamble to the proposed regulations expresses a concern that "treating partnership special basis adjustments as qualified property could result in inappropriate duplication of UBIA of qualified property (if, for example, the fair market value of the property has not increased and its depreciable period has not ended)." We understand this point with respect to tangible personal property. Over time, such property generally will not have a value greater than its initial value at purchase. Thus, allowing an increase in UBIA to reflect any IRC Section 1245 gain recognized by a selling partner could give rise to a duplication of UBIA.

However, this is not the case for real property. The value of real property, including residential real estate, often will increase over time. Not increasing UBIA to reflect any basis adjustment allowable under IRC Section 743(b) will not accurately reflect this increase in value.

We ask that the final regulations allow new partners engaging in an IRC Section 743(b) transaction an increase in UBIA for their allocable share of partnership property in an amount to not exceed the fair market value of the property at the time of the transaction.

REIT Dividends from Mutual Fund Should Qualify for 20 Percent Deduction

IRC Section 199A allows REIT dividends to qualify for the 20 percent deduction. The proposed regulations seem to limit this rule to REIT dividends earned *directly* by a REIT shareholder or through a relevant passthrough entity. We are concerned that the proposed regulations do not clarify that the millions of shareholders who invest in a REIT *indirectly* through a mutual fund are eligible for the deduction as well.

There is no policy rationale to deny the 20 percent deduction to a dividend attributable to a REIT holding because the REIT is held in a mutual fund rather than directly. Mutual funds are a sensible choice for many investors as, among other attributes, they enable investors to diversify their holdings.

NMHC/NAA request that the Treasury Department and the Internal Revenue Service use their statutory authority under IRC Section 199A(f)(4) to correct this issue prior to issuing final regulations. This section provides that "The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section, including regulations – for the application of this section in the case of tiered entities." Our view is that the tiered entity concept is directly applicable to a REIT dividend flowing from a mutual fund holding.

Modification to the Aggregation Rules

The proposed regulations allow taxpayers to elect to aggregate qualifying business activities for purposes of the IRC Section 199A deduction provided several conditions are satisfied. The preamble to the regulations rejects the use of the aggregation rules of IRC Section 469 because IRC Section 469: (1) provides groupings based on "activities" instead of the "trade or businesses" as required by IRC Section 199A; (2) is a loss limitation rule; and (3) groupings may include specified service trades or businesses excluded from IRC Section 199A. While NMHC/NAA take no position on this proposed rule in a non-real estate context, we urge the Treasury Department and Internal Revenue Service to reassess this issue from a real estate perspective.

Specifically, we request that the final regulations allow any taxpayer to *elect* to treat all real estate activities as a single trade or business for purposes of calculating the IRC Section 199A deduction so long as: (1) that taxpayer also elects to aggregate all real estate activities under IRC Section 469(c)(7); (2) there is a common general partner with respect to all aggregated real estate trades or businesses; (3) all real estate trades or businesses being aggregated meet the IRC Section 162 definition of a trade or business; and (4) all real estate trades or businesses being aggregated meet the definition of a real property trade or business under IRC Section 469(c)(7)(C). Taxpayers should be allowed to group trades or businesses that meet all the requirements above but vary only on which general partner is common to trades or businesses being aggregated. If these requirements are not met or an election is not made, the proposed aggregation election rules under IRC Section 199A should apply.

We ask Treasury and the Internal Revenue Service to make these modifications to promote administrative convenience and reduce taxpayer burdens with respect to the real estate industry. Under current law, IRC Section 469(c)(7) specifically addresses the aggregation of real estate activities for owners, developers, managers and investors of real estate. There is little reason to force these taxpayers to make an entirely separate set of calculations with regard to the aggregation rules under IRC Section 199A. Moreover, it is critical to note that aggregation rules are especially important in the real estate and multifamily industry, making it all the more vital that aggregation regimes applicable to real estate are both uniform and well considered.

Many real estate participants form or invest in a separate entity (e.g., a partnership) with respect to each project in which they are involved. For example, a general partner representing the firm "Multifamily Development Specialists" could be leading multiple partnerships, each with a wholly different set of investors. While that general partner's trade or business is undeniably multifamily real estate and is even representing a single firm, the proposed IRC Section 199A regulations would not enable that partner to group each partnership into a single trade or business due to varying owners of each deal.

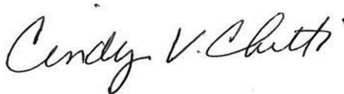
We further note that our proposal would only allow the aggregation of real estate trades or businesses meeting the IRC Section 162 and IRC Section 469(c)(7)(C) thresholds that have a common general partner. These strictures are designed to meet the proposed regulations' desire to limit aggregation to legitimate single trades or businesses. Furthermore, given the definition of real estate activities provided for in IRC Section 469(c)(7)(C), there is no risk that this proposal would include activities or income attributable to specified services. We also note that other portions of the *Tax Cuts and Jobs Act* specifically reference IRC Section 469 with respect to the tax treatment for real estate, including the interest deduction disallowance portion of the Act.

Finally, the proposed regulations request comment on whether the aggregation rules proposed for purposes of IRC Section 199A should apply for purposes of IRC Sections 469 and 1411. NMHC/NAA strongly oppose such a proposal. Real estate has long operated under IRC Section 469, and the proposed rules under IRC Section 199A would prevent grouping of activities in many instances given that investors in each real estate deal often vary. Extending the grouping method proposed for IRC Section 199A to IRC Section 469 could extremely disruptive and detrimental with no obvious benefit. The active and passive rules under IRC Section 469, which are now well understood in the real estate context, also effectively inform whether a real estate participant will be liable for tax under IRC Section 1411. Today's rules appropriately impose net investment income tax on passive investment income while exempting active income. There is no reason to modify current-law practice.

We believe the new and novel pass-through deduction will lead to further questions and concerns being raised. We look forward to working with the Treasury Department on additional matters related to the provision as the regulatory process moves forward to ensure this deduction is as effective as possible.

NMHC/NAA thank you for considering our views. We again congratulate you on issuing these proposed regulations and hope to work with you to make them as administrable and effective as possible. Please do not hesitate to contact Cindy Chetti, NMHC's Senior Vice President of Government Relations, at 202-974-2300 should any questions arise.

Sincerely,



Cindy V. Chetti
Senior Vice President of Government Affairs
National Multifamily Housing Council

Gregory S. Brown
Senior Vice President of Government Affairs
National Apartment Association