NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

Statement of the

National Association of Real Estate Investment Trusts®

to the

Senate Finance Committee

Regarding the Hearing Held on June 16, 2009 Regarding

Climate Change Legislation: Tax Considerations

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The National Association of Real Estate Investment Trusts® (NAREIT) respectfully submits these comments in connection with the hearing of the Committee on Finance held on June 16, 2009, regarding “Climate Change Legislation: Tax Considerations.” NAREIT thanks the Chairman, the Ranking Member and the Committee for the opportunity to provide these comments. NAREIT supports Congressional efforts to enact comprehensive legislation that encourages greater energy efficiency. To the extent that such legislation authorizes grants for activities designed to encourage greater energy efficiency, and as further described below, NAREIT encourages the adoption of clarifying language to ensure that real estate investment trusts (REITs) are able to fully participate in such activities. Rather than potentially requiring governmental resources to clarify at a later date REITs’ ability to participate in the activities encouraged by such grants, it is more efficient for Congress to include such language in any climate change legislation it considers.

NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

EXECUTIVE SUMMARY

Recently, Congress has undertaken several efforts to encourage energy efficiency and environmentally responsible retrofitting and development practices in residential and commercial buildings, as well as to promote economic stimulus. NAREIT understands that Section 262 of the energy-related bill recently approved by the Senate Energy Committee currently contains provisions that also would allow for grants to states for state-administered energy efficiency retrofit programs (Retrofitting Grants). These Retrofitting Grants are designed to encourage recipients to make their buildings more energy efficient.

By way of background, REITs are widely held companies that combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, hotels, shopping centers, offices, health care facilities, timberlands, and warehouses. If REITs meet a number of requirements designed to ensure that they are focused on long term real estate investment, and if they distribute at least 90% of their income annually, they are entitled to deduct distributions so that their income is taxed only at the shareholder level. As of December 31, 2008, REITs owned an estimated 6 billion square feet of commercial space. Buildings account for 40% of all energy use and almost 70% of all electrical energy use in the United States.

As the 111th Congress continues to consider comprehensive energy legislation that includes grants for energy improvements for commercial and residential buildings, NAREIT encourages the adoption of clarifying language to ensure that REITs, as significant owners of U.S. real estate, are able to undertake fully in such improvements. Specifically, and as further described below, such language would treat Retrofitting Grants as qualifying assets that generate qualifying income under the respective REIT tests. Because REITs own and control a significant amount of commercial real estate assets in the United States, adoption of these provisions would encourage REITs to retrofit properties for greater energy efficiency, thereby furthering Congressional policy to encourage energy reductions.

DISCUSSION

I. Efforts to Encourage Energy Efficiency

Recently, both the Obama Administration and Congress have indicated their intent to enact legislation that promotes greater energy efficiency. Congress enacted and on February 17, 2009, President Obama signed into law economic stimulus legislation, the *American Recovery and Reinvestment Act of 2009*, which includes a provision that provides an outright grant for companies that invest in certain energy projects (Energy Grants). More recently, the House Energy and Commerce Committee approved H.R. 2454, *The American Clean Energy and Security Act*. Section 202 of this proposal provides for Retrofitting Grants (called "REEP Grants" in the legislation) to facilitate the retrofitting of existing buildings across the United States to achieve cost-effective energy efficiency savings of 20% or more. We understand that Section 262 of legislation recently approved by the Senate Energy Committee also would authorize similar Retrofitting Grants.

II. REITs

A. Background

Congress created the REIT approach to real estate investing in 1960 to facilitate investment in large-scale, significant income-producing real estate by investors from all walks of life. Based in part on the rationale for mutual funds, Congress decided that an appropriate way for the average investor to access investments in larger-scale commercial properties was through pooling arrangements. In much the same ways as shareholders benefit by owning a portfolio of securities in a mutual fund, the shareholders of REITs can unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors, particularly: greater diversification through investing in portfolios of properties rather than single buildings and expert management by experienced real estate professionals.

B. REIT Income and Asset Test Requirements

In exchange for distributing at least 90% of their annual taxable income to shareholders, and for satisfying a number of other requirements, federal law grants REITs a dividends paid deduction so that their income is taxed at the shareholder level. In 2008, REITs distributed over $17 billion to shareholders. As relevant here, at least 75% of the value of a REIT's assets quarterly must consist of specifically delineated "real estate assets" such as interests in real property and mortgages secured by real property (the Asset Test). Furthermore, at least 75% of a REIT's annual gross income must be from specifically delineated income sources such as "rents from real property" (as such term has been defined) and interest on mortgages secured by real property (75% Income Test). At least 95% of a REIT's annual gross income must be from items that qualify for the 75% Income Test, as well as other passive types of income like non-real estate interest and dividends (the 95% Income Test, and together with the 75% Income Test, the Income Tests). Failure to satisfy these (and other) requirements can result in the draconian penalty of loss of REIT status.

C. Recent Congressional and IRS Clarification of Income and Asset Test Requirements

Since the authorization of REITs in 1960, Congress and the IRS have refined the definitions of qualifying "real estate assets" under the Asset Test and real estate-related income under the Income Test in order to conform to changes in the real estate marketplace. For example, in last year's *Housing and Economic Recovery Act of 2008* (Pub. L. 110-289) (the 2008 Act), Congress amended the Income Tests so that foreign currency gains incurred as part of a REIT's real estate business overseas would not be taken into account under the Income Tests. Similarly, the 2008 Act treats a REIT's foreign currency owned in connection with its business as a REIT specifically as a good real estate asset. Additionally, Congress provided the IRS with authority in the 2008 Act to determine whether specific types of income not specifically listed as qualifying REIT income are in fact qualifying types of income for the Income Tests. This legislation clarifies that a REIT may earn certain income and hold assets consistent with its core mission as a REIT without having such income and/or assets negatively affect its tax status as a REIT. Finally, while not REIT-specific, Congress provided that the Energy Grants authorized in the 2009 stimulus legislation, the *American Recovery and Reinvestment Act* of 2009, specifically are excluded from the gross income of the recipients of such grants.

Similarly, the IRS also has ruled privately numerous times that real estate-related assets and income not specifically listed in the Tax Code as qualifying REIT gross income or assets, such as refunds of state and local tax credits attributable to real estate investment, nevertheless are considered qualifying income or assets or are not taken into account in analyzing those rules.[1] However, these private rulings cannot be relied upon as precedent. In order to conserve vital IRS resources in the future and prevent the need for additional private rulings, it would be beneficial for Congress to clarify in current legislation that Retrofitting Grants are qualifying REIT assets that generate qualifying REIT income. Retrofitting Grants would be provided to REITs in connection with REITs' core mission of investing in real estate — in order to make their properties more energy efficient and therefore more desirable.

III. Retrofitting Grants: Issue for REITs and Recommendation

A. Tax Issue for REITs: Potential Loss of REIT Status Without Clarifying Language

REITs currently own major commercial and residential real estate assets throughout the nation. As noted above, buildings account for 40% of all energy use and almost 70% of all electrical

[1] *See, e.g.*, PLR 200916014 (a claim for a refund of State taxes based upon State tax credits would not be considered in determining whether a REIT satisfies the REIT asset tests); PLR 200813009 (real estate intangibles were qualifying REIT assets); PLRs 200614024 and 200528004 (a REIT's taxable income associated with the receipt of State tax credits would not be taken into account in determining whether the REIT satisfied the REIT gross income tests).

energy use in the United States, and REITs owned an estimated 6 billion square feet of commercial space as of December 31, 2008. Thus, provisions encouraging REITs to undertake improvements leading to greater energy efficiency would be in furtherance of Administration and Congressional efforts to promote greater energy efficiency.

In order to maintain their tax status, REITs must comply with the Income and Asset Tests. If Congress enacts legislation authorizing Retrofitting Grants without specific provisions clarifying their treatment as qualifying REIT assets that generate qualifying REIT income, REITs may fear that receipt of such grants could jeopardize their status as REITs. As a result, REITs may be less likely to undertake the retrofitting activities these Retrofitting Grants are designed to encourage.

B. Recommendation: Include Language in Energy Legislation Clarifying that Retrofitting Grants Are Qualifying REIT Assets That Generate Qualifying Real Estate Income

Many REITs are undertaking significant steps to improve the energy efficiency of these assets, but more can be done. Grant programs and other direct incentives for energy efficiency would be welcome by the REIT community — but it is critical that these efforts take into account the particular requirements that govern REITs.

The above-described Income and Asset Tests limit the amount of non-qualifying income a REIT can earn and the assets a REIT can hold while still maintaining its tax status as a REIT. NAREIT requests that Congress consider including language to ensure that Retrofitting Grants are considered qualifying REIT assets, and that such grants are considered qualifying REIT income because they would be provided to REITs in furtherance of REITs' core mission of owning and operating professionally managed, income-producing real estate.

Including such clarifying language in any legislation would accelerate REITs' use of the Retrofitting Grants and would simultaneously limit the need to expend scarce governmental resources at a later time to clarify the tax treatment of such grants for REIT tax purposes.[2] To provide complete certainty to REITs desiring to undertake retrofitting projects, Congress still should clarify that Retrofitting Grants are qualifying REIT assets. Absence of such clarification would limit the usefulness of provisions designed to encourage energy efficiency to a significant segment of the commercial real estate industry well suited to deploy these new technologies.

NAREIT again thanks the Chairman, the Ranking Member and the Committee for the opportunity to submit these comments on this important issue.

[2] Alternatively, similarly to the treatment of Energy Grants in the 2009 stimulus legislation, language could be included that treats Retrofitting Grants as exempt from gross income.