NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

February 25, 2005

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Re: Clarification Requested Regarding the Non-Applicability of Sections 470 and 168(h) to REITs

Dear Messrs. Solomon and Korb:

This letter is being sent by the National Association of Real Estate Investment Trusts® ("NAREIT") regarding new section 470,[1] which limits the deductions allocable to property used by governmental or other tax-exempt entities. As you know, section 470 was enacted as part of the American Jobs Creation Act of 2004[2] (the "Act"). NAREIT is requesting that Treasury and/or the Internal Revenue Service (the "IRS") issue appropriate guidance to clarify that, for purposes of sections 470 and 168(h), a real estate investment trust ("REIT") is not a "pass-thru entity" within the context of section 168(h)(6)(E). Such guidance is necessary to avoid the unintended application of the loss limitation rules of section 470 to REITs with tax-exempt or foreign shareholders.

Section 470 prohibits a taxpayer from claiming a deduction in excess of the taxpayer's gross income with respect to the lease of "tax-exempt use property."[3] The term "tax-exempt use property" is defined by reference to section 168(h),

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1 For purposes of this letter, "section" refers to the Internal Revenue Code of 1986, as amended ("Code"), unless otherwise indicated.

2 Pub. L. No. 108-357, § 848.

3 Section 470(a).

which includes: i) tangible property leased to tax-exempt entities;[4] and, ii) any property owned by a pass-thru entity with a tax-exempt entity as an owner if the pass-thru entity's allocation of items to the tax-exempt does not constitute a qualified allocation.[5] Thus, under section 168(h) and, in turn, section 470, tax-exempt use property includes not only real property leased to tax-exempt entities but also all other real property, regardless of its use, owned by a pass-thru entity with a tax-exempt or foreign owner.[6]

Our concern arises from the fact that neither sections 470 and 168(h) nor the accompanying legislative history defines a pass-thru entity for this purpose. Adding to the uncertainty is the fact that, notwithstanding the general tax treatment of a REIT as a corporation, there are a few instances in the Code in which a pass-thru entity is defined to include a REIT.[7]

The statutory language and legislative history clearly indicate that REITs were not the target of this provision. Instead, section 470 was designed to prevent taxpayers from claiming tax benefits generated in "Sale-In Lease-Out" ("SILO") transactions,[8] which the IRS recently declared to be abusive tax avoidance arrangements.[9] First, a REIT by definition is required to be taxable as a domestic corporation.[10] 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.[11] 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. Unlike other Code sections, neither section 168 nor section 470 provides that REITs are pass-thru entities rather than C corporations.

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4 *Id.* § 168(h)(1).

5 *Id.* §§ 168(h)(6)(A), (E).

6 *Id.* § 168(h)(6)(A).

7 *Id.* §§ 1(h)(10)(B); 860E(e)(6)(B); 1260(c)(2).

8 H.R. Rep. No. 108-548, pt. 1, at 313–14 (2004) (noting that the prior law was ineffective in curtailing the ability of a tax-exempt entity to transfer tax benefits to a taxable entity through certain leasing arrangements); S. Rep. No. 108-192, at 198 (2003) (same).

9 Notice 2005-13, 2005-9 I.R.B. 1 (designating SILOs as a listed transaction).

10 Section 857(a)(3).

11 *See*, *e.g.*, section 469(a)(2), which applies the passive loss rules only to individuals, estates, trusts, personal service corporations, and **closely held** C corporations.

Second, even prior to the enactment of section 470, REITs generally had no incentive to engage in a SILO-type transaction because, unlike traditional pass-thru entities (*i.e.*, a partnership), REIT-level losses or credits do not flow through to its shareholders. Further, a REIT generally has little or no taxable income because it may deduct dividends paid to shareholders, and it must distribute most of its taxable income as dividends.[12] Given the tax treatment of REITs, there was no benefit to its shareholders for a REIT to create deductible losses through a SILO arrangement. In fact, one of the most attractive features of investing in a REIT is earning positive income through the high dividend yield that results from the requirement that a REIT must distribute at least 90 percent of its taxable income annually.[13] In most cases, investing in a SILO arrangement actually would have an adverse effect on a REIT because the losses associated with a SILO would decrease REIT taxable income, which, in turn, would decrease the all-important dividend yield of the REIT's stock. Further, presumably the promoters of SILOs price into the transaction tax benefits that investors receive from artificial losses or credits. Thus, SILO transactions should generate less cash to REITs and their investors compared to the economic leasing transactions that are the basis on which REIT investors evaluate REIT management.

A REIT is principally evaluated by the public markets based on the consistency of its income generating capacity and its ability to grow the income stream over time. Thus, a REIT property usually does not generate deductions in excess of income, other than when it is newly constructed or renovated and has not yet "stabilized" its tenant base. Yet, even though section 470 would rarely operate to suspend losses for a REIT property, an SEC-registered REIT would be compelled to undertake substantial verification procedures to document each property's profitability. Public REITs already are expending millions to comply with section 404 of the Sarbanes-Oxley Act, and to layer on top of this extensive review procedure additional inquiries for the rare instance when a property generates a net loss that cannot even be allocated to a REIT shareholder is excessive, unnecessary, and unproductive both for the REIT and the IRS. This waste of resources is particularly acute with respect to transactions entered into in 2004, for which REITs are currently preparing SEC filings.

For these reasons, NAREIT respectfully requests that Treasury and/or the IRS promptly publish guidance stating that, for purposes of sections 470 and 168, a REIT is not pass-thru entity within the context of section 168(h)(6)(E).

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12 *Id.* § 561.

13 Id. § 857(a)(1).

NAREIT would welcome the opportunity to discuss this issue with you in more detail. Please contact me at (202) 739-9408 or Dara Bernstein at (202) 739-9446 to arrange a meeting or telephone conference. Thank you in advance for your prompt attention to this matter.

Respectfully submitted,

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