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April 7, 2011

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Re: Better Buildings Initiative and Real Estate Investment Trusts

Dear Ms. Hauser and Messrs. Novey and Parcell:

The National Association of Real Estate Investment Trusts (NAREIT)[1] appreciated the opportunity to meet with you on March 14, 2011 to discuss various options as to how to implement the Obama Administration's "Better Buildings Initiative" (BBI) with respect to REITs. As you know, the President has called on Congress to "redesign the current tax deduction for commercial building upgrades, transforming the current deduction with respect to energy efficient commercial building expenditures in section 179D[2] to a credit that is more generous and that will encourage building owners and real estate investment trusts (REITs) to retrofit their properties."

[1] NAREIT is the worldwide representative voice for real estate investment trusts (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.

[2] Unless otherwise provided, all "section" references herein shall be to the Internal Revenue Code of 1986, as amended (Code).

The Obama Administration's BBI proposal would modify existing section 179D with the ultimate goal of making "commercial building space in the United States 20 percent more energy efficient through cost-effective upgrades." Although section 179D has been part of the Code for a number of years, it is not widely used for a number of reasons,[3] including the fact that, with respect to REIT shareholders, the vast majority of the incentive is unavailable due to intricacies in the REIT tax rules relating to earnings and profits (E&P).

We are submitting this letter as a follow up to the March 14 meeting in order to present a number of options for how the BBI could be implemented with respect to REITs. As further described below, in order to provide the greatest incentive for REITs to undertake retrofitting expenditures, we encourage the Treasury Department to redesign section 179D to provide the greatest flexibility in its usage.

EXECUTIVE SUMMARY

In general, "buildings" account for 40% of all energy use and almost 70% of all electrical energy use in the U.S. As of December 31, 2010, SEC-registered REITs reported ownership of an estimated 6 billion square feet of commercial space. In addition to the 200 or so SEC-registered REITs, IRS data shows that another 1,200 or so entities file Forms 1120-REIT. Thus, REITs own and control a significant amount of commercial real estate assets in the United States that could benefit from retrofitting for reduced energy usage.

To remain consistent with the Administration's policy to retrofit existing buildings for energy efficiency, we request that the Treasury Department consider implementing the BBI in a manner that provides the greatest variety of alternatives in order to encourage REITs to invest in retrofitting projects. Otherwise, the proposed incentives to improve energy efficiency would not be available to a significant segment of the commercial real estate industry well suited to deploy these new technologies. While there is not tremendous tenant demand currently for retrofitting activities, our members would appreciate the opportunity to undertake these activities on a cost-effective basis in order to achieve lower operating costs that would appeal to new lessees.

In terms of making retrofitting and other energy-saving investments more cost-effective, NAREIT had supported an extension of the grant in lieu of tax credit passed as part of the 2009 stimulus bill (or a similar refundable tax credit as proposed in the prior Congress under H.R. 4599), provided that REITs would be fully eligible for such grant or tax credit. Although we

[3] As you know, NAREIT has been working with The Real Estate Roundtable, the U.S. Green Building Council and a number of other real estate and energy groups to improve Section 179D in a number of respects, including: 1) measuring energy savings compared to the existing building's baseline energy usage; 2) linking the amount of the incentive to energy savings achieved; 3) tying a portion of the tax incentive to implementation of efficiency measures and a portion to demonstrated energy savings; 4) allowing owners or tenants to claim some incentive for improving a substantial space within a building; 5) making the tax incentive useable for a broad range of building efficiency stakeholders, including REITs, and building types, including multifamily buildings; and, 6) modifying the incentive to include improvements in exterior lighting efficiency, as well as increased amounts for energy efficient cool roofs and historic buildings.

would support initiatives such as those, this letter will focus on ideas more in line with the BBI and its desire to make its incentives available to all real estate owners and operators.

As further described below, potential alternatives for improving the cost-effectiveness of retrofitting activities could include the ability to assign and/or transfer the credit to third parties (including tenants and service providers); indefinite carry forward of the credit to offset any potential REIT-level tax liability (including, but not limited to, tax on retained net capital gains); and the conversion of the credit to an economically equivalent deduction modeled after existing section 179D, provided that existing E&P rules are revised so that REIT shareholders could realize the benefit of the increased deductions from the REIT's taxable income.

DISCUSSION

I. REITs: BACKGROUND AND APPLICABLE RULES

A. Generally

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 regulated investment companies (mutual funds). REITs combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, health care facilities, hotels, shopping centers, offices, timberlands, and warehouses. Distributed earnings of REITs are subject to shareholder-level only taxation.

B. Specific Rules

1. REITs Must Distribute at least 90% of Taxable Income: Only One Level of Taxation for Distributed Earnings of Qualified REITs

To maintain REIT status, REITs must distribute at least 90% of their taxable income. Many REITs exceed this distribution requirement. In exchange for distributing taxable income and any net capital gains (and for satisfying a number of other requirements to ensure that REITs remain focused on the long-term investment in real estate), Federal law grants REITs (and mutual funds) a dividends paid deduction (DPD). In 2010, publicly traded REITs distributed more than $15 billion to their shareholders.

Thus, most, if not all, of a REIT's earnings are taxed only at the shareholder level. On the other hand, REITs pay the price of not having retained earnings available to meet their business needs. Instead, capital for growth and significant capital expenditures largely comes from new money raised in the investment marketplace from investors who have confidence in the REIT's future prospects and business plan.

2. 75%/95% Gross Income Tests

In order to ensure that REITs remain real estate-focused, REITs must satisfy two gross income tests annually. First, at least 75% of their gross income must be from real estate-related sources, including, among other things, rents from real property, interest on mortgages secured by real property, and gains from the sale of real property. Second, at least 95% of a REIT's gross income must be from those items included in the 75% gross income test as well as non-real estate passive income such as interest and dividends.

3. Asset Tests

REITs also must satisfy a quarterly asset test which requires that REITs be real estate-focused. Specifically, at the end of each calendar quarter, at least 75% of a REIT's assets (by value) must include real estate assets and cash and cash items (such as government securities).

4. Prohibited Transactions: 100% Tax on Sales of "Inventory" or Property Specifically Developed for Immediate Sale

Congress required REITs to be long-term investors in real estate. REITs may develop property for their own account that, once developed, they hold for investment. The relevant inquiry is whether the property is held as investment (for the long term) or as inventory as a dealer (for the short term). Gains attributable to the sale of "dealer property" are taxed to the REIT at a 100% rate.

II. ENERGY TAX INCENTIVES

A. Section 179D

In its present form, section 179D provides a deduction for certain expenses to enhance energy efficiency of commercial (and some multi-family) buildings. However, due to a quirk in technical REIT rules relating to E&P, REIT shareholders are denied most of the benefit of this tax deduction. Under current law, although section 179D authorizes certain deductions from taxable income in the year incurred, these deductions do not immediately reduce E&P, but instead reduce it pro rata over a five-year period. Unless the section 179D deduction also reduces REIT E&P by a corresponding amount, a REIT's shareholders will not get the benefit of the increased deduction because their taxable dividends are keyed off E&P, not the REIT's taxable income. Thus, under current law, REIT shareholders would receive only one-fifth of the benefit of the section 179D deduction per year. Further, section 857(d) prevents REITs from reducing E&P by deductions that are not allowable in reducing REIT taxable income, effectively limiting total E&P deductions to 20% of the section 179D amount (with the disallowed 80% amount resulting in an increase to the taxable portion of the REIT's distributions). As a result, deductions like those in section 179D currently provide limited incentive to REITs.

B. Energy Tax Credits – Current Law

1. Generally

Section 48 provides for an energy tax credit based on a percentage of the basis of qualified energy property placed in service during a taxable year. Qualified energy property includes property such as solar property, fuel cell property, small wind property, combined heat and power system property or geothermal property. The energy credit under section 48 is included as an investment credit for purposes of Subpart E of the Code, *Rules for Computing Investment Credit*, which includes sections 46 through 50. The investment credits of Subpart E are general business credits for purposes of Subpart D, under section 38. The energy credit is allowed as a credit against tax, limited under section 38(c)(4)(B)(vi) to income tax liability including any tentative minimum tax.

2. Special Rules: Section 50

As set forth below, and as applicable to REITs, section 50 provides a number of special rules with respect to the energy credit.

a. *Limitation for REITs based on DPD*

Section 50(c) requires that the tax basis in the property with respect to which an energy credit is determined under section 48 be reduced by one-half of the amount of the credit. Additionally, section 50(d) contains seven subparagraphs of special rules that are made applicable to the investment credits under Subpart E. Section 50(d)(1) states that rules similar to the rules of section 46(e) apply to the investment credit (relating to limitations with respect to certain persons, including REITs). The rules of section 46(e) provided that, in the case of a REIT, the qualified investment for purposes of the investment tax credit is equal to the “ratable share” of such qualified investment. Under section 46(e)(2)(B), a REIT’s “ratable share” is a ratio, the numerator of which is REIT taxable income under section 857(b)(2) determined without regard to any deduction for capital gains dividends (as defined in section 857(b)(3)(C)), and the denominator of which is REIT taxable income without regard to the dividends paid deduction under section 857(b)(2)(B).

In effect, this limitation reduces the energy credit under section 48 for a REIT based on the proportion of net income that is not paid out in dividends. As the amount of the credit is reduced, the corresponding amount of basis reduction required under section 50 is reduced as well, mitigating the differential that would otherwise exist between the amount of credit allowed against tax (generally zero in the case of REITs) and the amount of basis reduction. This limitation is therefore helpful to REITs. Absent this provision, REITs otherwise could be required to reduce basis by the entire amount of the credit even though the REIT obtained no benefit whatsoever from the credit as a result of having distributed 100% of its taxable income (and therefore having no tax liability against which to use the tax credit). The limitation operates by limiting the amount of basis reduction based on the amount of taxable income retained by the

REIT. The practical effect of this limitation is that REITs have not focused in any significant way on undertaking the types of projects that generate these credits.

Furthermore, sections 50(b)(1) through (4) provide that the credits generally are not available if the property subject to the credit is used outside the U.S., predominantly for lodging, by certain tax-exempt organizations, or by governmental units or by foreign persons or entities.

b. *Pass-Through to Tenants and REIT Limitation*

With respect to the energy credit under current law, section 50(d)(5) incorporates the rules of section 48(d) (as in effect on the day before the date of enactment [11/5/90] of the Revenue Reconciliation Act of 1990 (RRA 90)). In general, pre-RRA 90, section 48(d) provided that a lessor could elect to treat a lessee as having acquired property for its fair market value, essentially allowing the lessor to transfer the energy credit to the lessee (the tenant pass-through). Further rules regarding this election are contained in Treas. Reg. § 1.48-4(a). However, section 48(d)(1) specifically prevented a "person described in section 46(e)(1)" from being eligible for the tenant pass-through. Because REITs are listed in pre-RRA 90 section 46(e)(1)(B), under current law, REITs are statutorily precluded from passing through energy credits to tenants.

III. BBI PROPOSAL

On February 3, 2011, the Obama Administration set forth its BBI plan for, among other things, making "commercial building space in the United States 20% more energy efficient through cost-effective upgrades." Specifically, this proposal called on Congress to:

> redesign the current tax deduction for commercial building upgrades, transforming the current deduction to a credit that is more generous and that will encourage building owners and … **REITs** to retrofit their properties. These changes could result in a ten-fold increase in commercial retrofit take up, leveraging job-creating investments.

(Emphasis added.)

In its *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals* (the Green Book), the Treasury Department provided additional information regarding the BBI, by noting that "[s]**pecial rules** would be provided that would allow the credit to benefit **a REIT or its shareholders**." Green Book at p. 18 (Emphasis added.)

Although the Green Book did not specify what "special rules" would apply to REITs or their shareholders, page 200 of the *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2012* (Analytical Perspectives) stated that: [i]f a …REIT becomes entitled to the credit, **the REIT would be able to entitle its shareholders to the credit under regulations** prescribed by the Secretary of the Treasury."

(Emphasis added.)

At the outset, we note that passing through a tax credit to shareholders, while theoretically appealing, in practice would not be a real incentive. As we discussed earlier, most of our REIT members are widely held entities with thousands, if not millions, of shareholders. As a result, even a significant tax credit divided among so many shareholders is unlikely to amount to much tax savings per shareholder. Further, the capital markets treat REITs as a yield-based investment and expect REITs continually to increase their distributions. Most important is the actual distribution per share; the fact that a slightly reduced percentage of such distribution is in fact taxable does not resonate in the market. Finally, shareholders are likely to view an insignificant tax credit on their Form 1099-DIV as more of just one more immaterial box entry to interpret when completing their Form 1040. A number of other more desirable alternatives are set forth below. We recognize that these options would require the resolution of a number of technical issues, and we would be happy to work with you in order to resolve any of these.

IV. RECOMMENDATION FOR IMPLEMENTING THE BBI FOR REITS

Because different REITs own different property types, have disparate interests, and maintain different pay-out philosophies, we would encourage the Treasury Department to consider providing a number of choices for implementing the BBI in order to maximize the investment by REITs in energy efficient buildings.

A. Assignment/Transfer of Tax Credit

Other than making the tax credit refundable as noted above, the most direct and efficient way for the REIT to offset at least part of its cost in retrofitting existing buildings would be for it to assign or transfer the tax credit, assuming the expenditures could be traced to investments in energy efficiency and actual improvements in energy efficiency. This assignment or transfer could be structured in a number of ways: to completely independent third parties; to service providers in connection with actual retrofitting services; or to tenants, similar to existing rules that allow non-REITs to treat lessees as though they directly purchased the property. The ability to assign and/or transfer the credits, and treat the proceeds from such assignment/exchange as non-taxable (rather than gross income under section 856(c) or taxable income under Section 857(a)(1)), would be the most direct and efficient way for the REIT to monetize the credit and thereby obtain capital to offset its investment in highly energy efficient properties.[4]

We recognize your expressed concern about ensuring that the credit is used by only one taxpayer (and not sold and used multiple times). Based on the state-level experience, we believe that this concern could be resolved.

B. Carryforward of Tax Credit

As mentioned earlier, a REIT is required to distribute to its shareholders at least 90% of its taxable income for the taxable year. Both due to market demand for increasing distributions, and out of an abundance of caution, many REITs distribute all of their taxable income (leaving no tax liability for a credit to offset). Like mutual funds, REITs are permitted to elect and retain net capital gains, provided they pay the corresponding corporate tax liability attributable to such gains. REITs rarely exercise this option because the corporate tax liability generally offsets the benefit of retaining the cash for future investments, particularly because the market demands

[4] If the proceeds were treated as taxable income to the REIT, there would need to be confirmation that such income was qualifying real estate income and not subject to the prohibited transaction 100% tax rules.

increasing distributions. However, our members have indicated that it would be helpful as a cash management tool. If so, any REIT-level credit should include a rule that would permit any unused portion of the credit to be carried forward indefinitely and used to offset any tax liability. Further, the credit should not be limited by the REIT's distributions as is the current energy tax credit.

C. Conversion of Tax Credit to Economically Equivalent Deduction; Equivalent Deduction from Earnings and Profits

Because REITs generally do not have any Federal income tax liability that could be offset by tax credits, we believe that, to create any incentive for REITs to invest in energy reduction projects, REITs should be afforded the flexibility of claiming the incentive as a tax deduction, rather than a tax credit.

Furthermore, because a tax credit affords a dollar-for-dollar reduction in tax liability, while a tax deduction only reduces tax liability by the amount of the deduction multiplied by the tax rate applicable to the income, we recommend "grossing up" any deduction to achieve the same economic result as a tax credit. Finally, we recommend that any modifications to section 179D be coupled with a corresponding deduction for E&P purposes.[5]

In order to determine the amount of deduction necessary so that a taxpayer receives the same economic benefit as a taxpayer which receives a credit, the following formula is appropriate:

Credit = ["Grossed up" Deduction]*[tax rate]

Thus, "Grossed up" Deduction =[Credit] / [tax rate]

In simple terms, the value of the deduction that will equal the economic benefit of a credit will be equal to the credit divided by the tax rate (with the tax rate expressed in decimal format, *e.g.*, 35% as .35). Thus, the lower the tax rate, the higher the deduction needed (since the higher the tax rate is, the greater the tax savings from a deduction).

Because a REIT would be subject to the highest marginal rate of 35% to the extent that it retained any taxable income, and, accordingly, incurred Federal income tax liability, we suggest using a 35% tax rate. As an illustration, a tax credit of $100 could save a non-REIT taxpayer $100 in federal income tax liability. Assuming a 35% tax rate, in order for a deduction to provide

[5] In the previous Congress, Sens. Jeff Bingaman (D-NM) and Olympia Snowe (R-ME), introduced S. 3935, *Advanced Energy Tax Incentives Act of 2010*," that would have enhanced the deduction for energy efficient commercial buildings in section 179D and extended energy efficient home credits to apartments. It would have harmonized the deduction for energy efficient buildings with the deduction taken for E&P purposes, thereby providing additional encouragement for REITs to make these investments. Further, the Treasury Department has already recognized the need for E&P conformity for REITs in the cancellation of debt context. *See* Temp. Treas. Reg. § 1.108(i)-1T(d)(2)(i).

the REIT with the same economic benefit as a credit, the credit of $100 would need to be converted into a deduction of $285 ($100/.35=$284.9).

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Thank you for your consideration of our recommendations. Please contact me at (202) 739-9408 or Dara Bernstein, NAREIT's Senior Tax Counsel, at (202) 739-9446, if we can provide you with any additional information.

Respectfully submitted,

Tony M Edwards

Tony M. Edwards
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cc: Jeffrey Van Hove, Esq.