OFFICERS

Chair
Constance B. Moore
BRE Properties, Inc.

President and CEO
Steven A. Wechsler

First Vice Chair
Debra A. Cafaro
Ventas, Inc.

Second Vice Chair
Bryce Blair
AvalonBay Communities, Inc.

Treasurer
Donald C. Wood
Federal Realty Investment Trust

2009 NAREIT Board of Governors
Andrew M. Alexander
Weingarten Realty Investors
Thomas D. Bell, Jr.
Cousins Properties Incorporated
Kenneth Bernstein
Acadia Realty Trust
Jon E. Bortz
LaSalle Hotel Properties
David M. Brain
Entertainment Properties Trust
Richard J. Campo
Camden Property Trust
Richard B. Clark
Brookfield Properties Corporation
Christopher H. Cole
Cole Real Estate Investments
Arthur M. Coppola
Macerich
James F. Flaherty, III
HCP, Inc.
Edward J. Fritsch
Highwoods Properties, Inc.
Laurence S. Geller
Strategic Hotels & Resorts, Inc.
Jonathan D. Gray
Blackstone Real Estate Advisors
Randall M. Griffin
Corporate Office Properties Trust
Keith R. Guericke
Essex Property Trust, Inc.
William P. Hankowsky
Liberty Property Trust
Ronald L. Havner, Jr.
Public Storage, Inc.
Philip L. Hawkins
DCT Industrial Trust, Inc.
Mitchell E. Hersh
Mack-Cali Realty Corporation
David H. Hoster II
EastGroup Properties, Inc.
John B. Kilroy, Jr.
Kilroy Realty Corporation
Alan M. Leventhal
Beacon Capital Partners, LLC
Edward H. Linde
Boston Properties, Inc.
Peter S. Lowy
The Westfield Group
Craig Macnab
National Retail Properties, Inc.
Joel S. Marcus
Alexandria Real Estate Equities, Inc.
David J. Neithercut
Equity Residential
Dennis D. Oklak
Duke Realty Corporation
Jeffrey S. Olson
Equity One, Inc.
Edward J. Pettinella
Home Properties, Inc.
Walter C. Rakowich
ProLogis
Steven G. Rogers
Parkway Properties, Inc.
R. Scot Sellers
Archstone
Martin E. Stein, Jr.
Regency Centers Corporation
David P. Stockert
Post Properties, Inc.
Jay Sugarman
iStar Financial Inc.
Gerard H. Sweeney
Brandywine Realty Trust
Robert S. Taubman
Taubman Centers, Inc.
Lee M. Thomas
Rayonier, Inc.
C. Reynolds Thompson, III
Colonial Properties Trust
Thomas W. Toomey
UDR, Inc.
W. Edward Walter
Host Hotels & Resorts, Inc.
Scott A. Wolstein
Developers Diversified Realty Corporation
Mark E. Zalatoris
Inland Real Estate Corporation

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

August 7, 2009

Laurie Coady, Esq.
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Re: Subchapter M Reform

Dear Laurie:

As we have discussed, NAREIT would like to meet with the Joint Tax Committee to discuss a number of proposals that would reform and improve certain provisions in Subchapter M of the Internal Revenue Code relating to REITs.

NAREIT recommends the following legislative changes:

1. modify the "REIT Savings" rules to allow REITs to choose to apply an increased monetary penalty for a REIT test failure when the current "reasonable cause" standard is not met so long as the principal purpose of the failure is not to circumvent one or more of the REIT test requirements;
2. modify the preferential dividend requirement so that a distribution could be treated as preferential only if the principal purpose of distributing a dividend with a preference is to shift the tax consequences of the REIT's income among its shareholders of the same class of stock;
3. clarify the REIT income and asset tests to encourage REITs to work out, rather than foreclose on, both existing and newly acquired distressed mortgage loans;
4. update and modify the dealer sales safe harbor and corresponding provisions so that: a) a taxable REIT subsidiary (TRS) is allowed to provide the same services as an independent contractor without adverse tax consequences to the affiliated REIT; and, b) only sales of "interests in real property" are taken into account for purposes of the safe harbor;
5. authorize REITs to pass through existing and/or future tax credits for investment in "green" energy projects to their shareholders;
6. treat REIT debt securities as "real estate assets" in the same manner as real estate equity securities;
7. make permanent and extend to all REITs the treatment of mineral royalties as qualifying REIT income under section 856(c)(2);

1875 I Street, NW, Suite 600, Washington, D.C. 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

8. conform the REIT income and asset tests by treating personal property as a real estate asset if it amounts to less than 15% of the associated real property (as measured by fair market value or adjusted tax basis);
9. reduce the REIT real estate and passive income test from 95% to 90% to conform to the existing mutual fund rules;
10. modify the hedging rule of section 856(c)(5)(G) to allow hedges entered into to counteract another hedge to be treated as a qualifying hedge;
11. make permanent the treatment of gain from the sale of timber as qualifying REIT income under sections 856(c)(2) and (c)(3); and,
12. treat credits for carbon sequestration (carbon credits) as qualifying REIT assets and income from the sale of carbon credits attributable to the planting of timberland as qualifying REIT income.

DISCUSSION

I. MODIFY THE "REIT SAVINGS" RULES

The REIT Savings[1] provisions generally allow a REIT to remedy one or more failures to satisfy the REIT asset tests under section 856(c)(4), income tests under sections 856(c)(2) and (3), or "other" REIT requirements under section 856(g) by remedying the failure and paying a monetary penalty.[2] One requirement needed to remedy most of the REIT test failures is that the failure be due to "reasonable cause and not due to willful neglect." Along with the Investment Company Institute (ICI), NAREIT has met with Treasury Department and Internal Revenue Service (IRS) officials over the last several years to reach a consensus on how to make the REIT Savings rules work better for both taxpayers and the government.

As described in greater detail in Exhibit A to this letter, NAREIT recommends that current law treatment be retained for those REITs that may choose to avail themselves of its provisions. For those REITs that are concerned about a REIT test failure and do not have sufficient assurances of "reasonable cause," an additional option would be available so that they could choose to pay a higher monetary penalty. Furthermore, relief under the latter approach would not be available if the principal purpose of the violation was to circumvent one or more of the REIT test requirements. The ultimate penalty of de-REITing thus would be limited by the same standard that now applies to the loss of S corporation status as a result of the failure to meet the single class of stock requirement. We understand that ICI would like to have these modifications also apply to mutual funds.

---

[1] The REIT Savings provisions are codified as Internal Revenue Code sections 856(c)(7) and 856(g)(5). They originated as Title III of H.R. 1890 and S. 1568, the REIT Improvement Act of 2003, which was enacted as part of the American Jobs Creation Act of 2004, Pub. L. No. 108-357. A related provision, section 856(c)(6), which imposes a tax in connection with the failure to satisfy the REIT gross income tests under sections 856(c)(2) and (c)(3), originated as part of the Tax Reform Act of 1976, Pub. L. No. 94-455.
[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the Code).

II. TREAT DISTRIBUTIONS AS PREFERENTIAL DIVIDENDS ONLY WHEN THE PRINCIPAL PURPOSE OF THE PREFERENCE IS TO SHIFT TAX CONSEQUENCES AMONG THE REIT'S SHAREHOLDERS OF THE SAME CLASS

Under section 857(a), a REIT must distribute at least 90% of its REIT taxable income annually as a dividend in order to maintain its REIT status. If the REIT does so, and meets the other requirements in Subchapter M of the Code, the REIT is entitled to a dividends paid deduction (DPD) as defined in section 561. Section 562 contains rules applicable in determining the definition of the word "dividend" under section 561. Section 562(c) provides that "[t]he amount of any distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference."

Sections 561 and 562 were enacted to deal with the rules relating to "personal holding companies" (PHCs). These are anti-abuse provisions designed to prevent a small group of individuals from shifting income into a controlled corporation with respect to which (at the time) it would have been subject to a lower effective tax rate than if it remained with the individuals. PHCs can claim a DPD for distributed income, but only to the extent that the distributions are not "preferential" as defined in section 562(c).

If a distribution is viewed as a preferential dividend, it is not deductible and can cause a REIT to fail to satisfy the 90% distribution requirement. Compliance with its requirements compels REITs to expend a significant amount of resources, and over the years, the IRS has allocated much time and resources to closing agreements that remedy inadvertent failures of the preferential dividend rules.

The connection between the preferential dividend rule as it relates to PHCs and as applied to REITs is not completely clear. Congress may have believed that the rule achieved some type of shareholder fairness in distributions. Notably, the preferential dividend rule allows for shareholders of different classes of stock to receive different distributions so long as the preference is inherent in the particular stock class. Furthermore, the current preferential dividend rule results in the apparent disqualification of an entire distribution due to a minor "foot fault" involving a rounding error or incorrect shareholder addressee that causes shareholders of a particular class to receive disparate distributions (albeit varying only by *de minimis* amounts).[3]

[3] The Treasury Department and IRS have included an item on their Priority Guidance Plan for the past two years that would address corrections of minor errors by REITs and regulated investment companies (RICs). This guidance presumably would address preferential dividends occurring as a result of a minor error. *See* 2007–2008 Priority Guidance Plan [http://www.irs.gov/pub/irs-utl/2007-2008_pgp_initial.pdf] and 2008–2009 Priority Guidance Plan [http://www.irs.gov/pub/irs-utl/2008-2009_gpl.pdf]. While NAREIT fully supports the issuance of this guidance in the absence of any legislative change, NAREIT believes that it would be more appropriate for the preferential dividend rule to apply only if the principal purpose of distributing a dividend with a preference is to shift tax consequences among the REIT's shareholders of the same class.

Another example of an inadvertent violation that does not affect shareholder returns is when a REIT pays one class of shareholder the correct amount minutes before another class of shareholder in contravention of an ordering sequence in the REIT's corporate documents.

The body of federal and state securities and corporate law has evolved significantly since the 1960 enactment of the preferential dividend rule. As a result, shareholders are already protected against any real economic harm under state corporate laws and state laws involving contracts. NAREIT believes that the preferential dividend rule is not needed to prevent tax avoidance.[4] Furthermore, the burden it creates on REITs and the IRS far outweighs any benefit it may achieve.

To the extent that there is any belief that REITs could use preferential distributions to shift tax liability for the REIT's income among its shareholders, NAREIT suggests that a refinement be added to the existing rules under section 562(c) that would treat a distribution as preferential only if the principal purpose of distributing a dividend with a preference is to shift tax liability for the REIT's income among its shareholders of the same class.

III. CLARIFY THE REIT INCOME AND ASSET TESTS WITH RESPECT TO EXISTING AND NEWLY ACQUIRED DISTRESSED DEBT

A. Modification of REIT's Existing Mortgage Loans

Section 856(c)(5)(B) defines the term "real estate assets" to include, among other things, interest in mortgages on real property. Section 856(c)(3)(B) includes as qualifying income under the 75% gross income test "interest on obligations secured by mortgages on real property or on interests in real property." The Code does not explain how to treat a mortgage loan that is partially secured by real property either for purposes of the asset test or the income test.

1. *Apportionment for Loans Secured by Both Real and Personal Property*

Treas. Reg. § 1.856-5(c) generally addresses whether interest income on a mortgage loan is treated as qualifying income for purposes of the 75% gross income test in section 856(c)(3) applicable to REITs when the loan is secured by both real property and other property.[5] To the extent that the "loan value of the real property" securing the loan exceeds the "amount of the loan," all of the interest income on the loan is treated as qualifying income. To the extent that the "amount of the loan" exceeds the "loan value of the real property," a portion of the interest

---

[4] For further discussion of this issue, *see* New York State Bar Association, Tax Section, Report on the Application of Code Section 562(c) to Regulated Investment Companies and Real Estate Investment Trusts (April 7, 2008) [http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1153Letter.pdf].

[5] Although Treas. Reg. § 1.856-5(c) by its terms applies only to the 75% income test, PLR 199923006 indicates that an apportionment must be made for purposes of the asset tests when a mortgage loan is undersecured. Because there is no precedential guidance on how to evaluate an undersecured loan for purposes of the REIT asset tests, NAREIT recommends that the principles of Treas. Reg. § 1.856-5(c) be incorporated into statutory language with respect to both the income and asset tests. *See* Rev. Proc. 2003-65, 2003-2 C.B. 336 (citing Treas. Reg. § 1.856-5(c) generally in connection with guidelines as to when a loan secured by a partnership interest will be treated as a qualifying real estate asset that generates qualifying real estate income).

income is treated as nonqualifying. The "loan value of the real property" is generally the value of the real property securing the loan on the date the REIT committed to originate or acquire the mortgage loan. The "amount of the loan" is generally the highest principal amount of the loan during the applicable year.

2. *"Significant Modification" Triggers Deemed Exchange and Potentially Adverse REIT Tax Consequences*

In the case of a REIT that works out a mortgage loan in default or when default is reasonably foreseeable, the modification will likely be treated as a "significant modification" under Treas. Reg. § 1.1001-3. A "significant modification" triggers a deemed exchange of the old loan for the modified loan. In a workout scenario, the "loan value of the real property" on the modified mortgage loan may be less than its stated principal amount.

To the extent that the IRS treats a deemed exchange under Treas. Reg. § 1.1001-3 as a new "commitment" to acquire the modified mortgage loan under Treas. Reg. § 1.856-5(c), working out a mortgage loan with the borrower may cause a significant portion of the post-modification interest on the mortgage loan to be treated as nonqualifying income for the 75% gross income test and a corresponding portion of the loan to constitute a nonqualifying asset for the 75% asset test, even though when the REIT first originated or acquired the loan, all of the interest from the loan had been qualifying income for the 75% gross income test, and the entire loan had qualified as a real estate asset. This result, adversely converting to nonqualifying what had been considered entirely a real estate asset that generated only qualifying real estate-related income, can discourage REITs from working out mortgage loans.

3. *Recommendations*

a. ***No Re-Testing of Mortgage Loan for REIT Tax Purposes if Loan is in Default or Default is Reasonably Foreseeable***

To encourage REITs to work out mortgage loans (clearly a worthy policy goal considering how constrained access to capital is in today's market), NAREIT recommends that a REIT should not have to re-test the qualification of a mortgage loan under the asset test (or the interest on such a loan under the income test) merely because the REIT consents to a "significant modification" of the loan under Treas. Reg. § 1.1001-3.

NAREIT believes that it is appropriate to allow a REIT to benefit from this rule only when the mortgage loan is in default or when default is reasonably foreseeable, the same standard used for REMICs under Treas. Reg. § 1.860G-2(b)(3). This requirement would ensure that the requested protection from fluctuations in market value is provided only when the modification is prompted by events outside of the REIT's control (*i.e.*, the borrower's default or reasonably foreseeable default on the loan).

We note that this proposal is consistent with, and very similar to, the treatment of "significant modifications" for REMICs under Treas. Reg. § 1.860G-2(b)(3)(i) when the terms of a mortgage

loan are changed as a result of "default or a reasonably foreseeable default." Indeed, NAREIT proposes using the same "reasonably foreseeable default" standard in the requested guidance for REITs.[6] The IRS has issued guidance in the REMIC context further liberalizing that standard for loans modified as a part of private and government modification programs, which guidance further assures REMICs that modifying distressed loans will not jeopardize their tax classification.[7] NAREIT believes that it is similarly appropriate to allow REITs to modify loans that are in a distressed condition without jeopardizing their tax classification.[8]

b. ***Incorporate Apportionment Concept of Regulations into Statute for Income and Asset Test Purposes***

NAREIT also recommends incorporating the apportionment concept of Treas. Reg. § 1.856-5(c) into the statutory language with respect to the REIT gross income and asset tests to provide greater clarity to REITs in connection with the treatment of undersecured loans and loans secured by both real and personal property for purposes of the REIT gross income tests of sections 856(c)(2) and (3) and the REIT asset tests of section 856(c)(4). We point out, however, that we recommend codifying the apportionment concept of Treas. Reg. § 1.856-5(c) only if part of the codification includes the proposal discussed in section B.2. below with respect to newly acquired distressed mortgage loans. Otherwise, the codification of the apportionment concept could produce an inappropriate result for those loans.

B. Newly Acquired Distressed Mortgage Loans

1. *Conservative Application of Existing Regulation Creates Disincentive for REITs to Assist Distressed Borrowers, Contrary to Government's Policy Goals*

When a REIT acquires a mortgage loan in a distressed condition, the value of the real property securing the loan likely has decreased, but the stated principal amount of the loan likely has not. A restrictive reading of the definition of "amount of the loan" under Treas. Reg. § 1.856-5(c) in the context of a distressed mortgage loan could result in a REIT recognizing a significant amount of nonqualifying income and holding a nonqualifying asset—even though the price paid by the REIT for the distressed mortgage loan is less than the fair market value of the real property securing the loan on the acquisition date.

The government's response to the credit crisis has evidenced the policy goals of: 1) encouraging lenders to modify mortgage loans to avoid foreclosure; and, 2) injecting liquidity into the market

[6] NAREIT and other national real estate organizations have proposed that the Treasury Department temporarily permit REMICs greater latitude in modifying loans as a result of the current economic crisis [http://www.reit.com/Portals/0/PDF/NREO-REMICTreasuryLetter.pdf]. NAREIT suggests that any future modifications to this "reasonably foreseeable default" standard in Treas. Reg. § 1.860G-2(b)(3)(i) also apply in the REIT context.

[7] Rev. Proc. 2009-23, 2009-17 I.R.B. 1; Rev. Proc. 2008-47, 2008-31 I.R.B. 272.

[8] NAREIT does not seek legislation that would limit the federal income tax consequences of a "significant modification" under Treas. Reg. § 1.1001-3 beyond the consequences under Treas. Reg. § 1.856-5(c). Thus, a REIT may still recognize gain or loss upon a "significant modification."

for distressed debt, mortgage loans, and mortgage-backed securities. Uncertainty regarding the application of Treas. Reg. § 1.856-5(c) to mortgage loans that are modified in connection with a default and newly acquired distressed mortgage loans impedes the ability of REITs to advance those goals.

Accordingly, NAREIT recommends that the Code be redrafted to override the existing regulations so that the "amount of the loan" under Treas. Reg. § 1.856-5(c) for a mortgage loan with market discount should be based on the REIT's highest adjusted tax basis in the loan during the taxable year.[9] Thus, the REIT would measure whether the loan is fully secured by the underlying real estate based on the amount paid, rather than the full outstanding principal amount of the loan.

2. *Recommendation: Limit "Principal Amount" to Amount REIT May Receive Tax-Free for Repayment of the Loan*

NAREIT believes it is appropriate and consistent with the treatment of market discount generally to limit the "principal amount" for purposes of Treas. Reg. § 1.856-5(c) to the amount that a REIT may receive tax-free upon repayment of the mortgage loan. To the extent a REIT receives a payment attributable to the stated principal amount in excess of its adjusted tax basis, that payment will be treated as interest income or gain for federal income tax purposes.

Accordingly, using that purchase price as the "amount of the loan" under a new statutory provision that incorporated Treas. Reg. § 1.856-5(c) would conform the interpretation of that regulation, which was promulgated in 1981, with the provisions of the Code addressing market discount, which were added in 1984.

IV. MODIFY AND UPDATE DEALER SALES SAFE HARBOR AND CORRESPONDING PROVISIONS

A. Conform Rental Property Safe Harbor to Timber Safe Harbor and Permanently Authorize Use of TRS in Addition to Independent Contractor to Undertake Marketing Activities

1. *Evolution of REITs, Independent Contractors and Taxable REIT Subsidiaries*

Prior to the enactment of the Tax Reform Act of 1986 (the 86 Act), REITs were only allowed to own their properties, not to *operate or manage*, their properties. As a result, REITs were required to provide all property-related services through independent contractors.[10] The 86 Act updated

[9] As Treas. Reg. § 1.856-5(c)(3) bases the "amount of the loan" on the highest principal amount during the year, NAREIT believes it is appropriate in the distressed mortgage context loan to base the "amount of the loan" on the highest adjusted tax basis during the year, rather than the adjusted tax basis upon acquisition.

[10] The specific tax provisions requiring REITs to use independent contractors were somewhat complex. Under section 856(c)(2) and (c)(3), the majority of a REITs income must be from certain real estate-related and passive sources. One type of income is "rents from real property" as specifically defined. The term "rents from real

the REIT rules to allow REITs to perform certain "customary" services for tenants; non-customary services still required the use of an independent contractor.

As the real estate industry evolved into more of a customer-oriented service business, REITs were disadvantaged because they were unable to provide "cutting edge" services until those services were considered customary. To adapt the REIT rules to the changing real estate industry landscape, Congress enacted the REIT Modernization Act (RMA) in 1999.[11]

The RMA authorized a REIT to own up to 100% of the voting stock and value of a corporation so long as the REIT and the corporation make a TRS election. The TRS may engage in virtually any activity (including those which would generate non-qualifying REIT Income), but, as a trade-off, the TRS is subject to corporate-level tax on its taxable income. A 100% penalty tax applies to the extent income or deductions are improperly shifted between a REIT and related TRSs. In a sense, a TRS is a "super independent contractor," allowing the REIT to satisfy tenant demands by providing services through a TRS, while at the same time subjecting income earned by the TRS to full corporate-level tax.[12]

While the RMA generally authorized a REIT to use its TRS (in addition to an independent contractor) to provide non-customary services, there are a number of provisions in Subchapter M of the Code that apply only if an independent contractor from whom the REIT "does not derive or receive any income" is used. However, given the policy behind the authorization of TRSs, namely, to better allow REITs to serve their tenants and customers, these provisions should be updated to allow REITs to use *either* an independent contractor or a TRS, as described below.

2. *Prohibited Transactions Safe Harbor*

A REIT may be subject to a 100% "prohibited transactions" (or "dealer sales") tax on net income from sales of property held primarily for sale to customers in the ordinary course of business.[13] In 1978, Congress recognized the need for a bright line safe harbor test to determine whether a REIT's property sale constituted a prohibited transaction.[14] Congress further liberalized these rules in 1986 to comport better with dealer sales case law and industry practice and to simplify a REIT's ability to sell investment property without fear of being taxed at a 100% rate.[15] Congress

---

property" excludes "impermissible service income" as defined in section 856(d)(7). Prior to the amendment by the REIT Modernization Act (discussed below), the term "impermissible services income" in section 856(d)(7) meant "any amount received or accrued directly or indirectly by the [REIT] for services furnished or rendered by the [REIT] to the tenants of such property, or managing or operating such property." However, section 856(d)(7)(C) provided that services shall not be treated as "furnished or rendered, management or operation provided" by the REIT if furnished or rendered through an independent contractor from whom the REIT "does not derive or receive any income."

[11] Sections 541-571 of the Pub. L. No. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999. The provisions of the RMA were effective beginning in 2001.

[12] The RMA expanded section 856(d)(7)(C) to provide that services will not be treated as furnished by the REIT if provided through *either* an independent contractor from whom the REIT derives no income or a TRS.

[13] Section 857(b)(6)(A).

[14] Section 363 of the Revenue Act of 1978, Pub. L. No. 95-600.

[15] Section 666(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514.

modified the safe harbor most recently in connection with the enactment in 2008 of Pub. L. No. 110-289, the Housing and Economic Recovery Act of 2008 (the Act).[16]

a. ***Rental Property Safe Harbor***

The safe harbor exception for rental property in section 857(b)(6)(C) (Rental Property Safe Harbor) provides that a sale of a "real estate asset" will not be classified as a prohibited transaction if it meets all of the following requirements:

1) the REIT held the property for at least two[17] years;

2) capital improvements that the REIT made to the property during the two years preceding the date of sale did not exceed 30% of the property's net selling price (30% Rule);

3) a) the REIT did not make more than seven sales of "property" during the year (Seven Sales Rule); or, b) (i) the aggregate adjusted bases of all "properties" sold during the year do not exceed 10% of the aggregate bases of all of the REIT's assets as of the beginning of the year, or (ii) the fair market value of all "properties" sold during the year does not exceed 10% of the fair market value of all of the REIT's assets as of the beginning of the year (10% Rule);

4) in the case of land or other improvements not acquired through foreclosure or lease termination, the REIT held the property for the production of rental income for at least two years; and,

5) if the REIT is relying on the 10% Rule, substantially all of the marketing and development expenditures were made through an independent contractor, from whom the REIT receives no income (the Rental Marketing Rule).

Congress included the Rental Marketing Rule as part of a broader updating of the REIT rules, including the prohibited transactions safe harbor, in the Tax Reform Act of 1986,[18] 15 years before REITs were allowed to use TRSs. Although not clear from the legislative history, Congress may have created the Marketing Rule to carry out its original goal that REITs be long-

[16] The Act contains all but one of the titles that were contained in H.R. 1147 and S. 2002, the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA). Sections 3031-3071 of Pub. L. No. 110-289.
[17] The RIDEA provisions shortened the safe harbor holding period in section 857(b)(6)(C) from four years to two years. NAREIT recommends that the reference in section 856(j)(4)(A) that deems a REIT to have held property for at least "4 years" in the context of shared appreciation mortgages should be changed to "2 years" in order to conform to the change in section 857(b)(6)(C).
[18] The RIDEA provisions enacted in 2008 modified this basis rule to allow a REIT to satisfy the 10% Rule by measuring properties sold either by aggregate basis or aggregate fair market value.

term investors in real estate.[19] It is possible that Congress believed that the REIT itself should not engage in marketing its properties because marketing can be a key determinant of being a dealer.

b. ***Timber Property Safe Harbor***

More recently, section 321 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, established a similar dealer sales safe harbor for sale of timberland in section 857(b)(6)(D) (Timber Property Safe Harbor). Although the Timber Property Safe Harbor of section 857(b)(6)(D) is generally similar to the Rental Property Safe Harbor of section 856(b)(6)(C), section 856(b)(6)(D) does reflect some refinements to the original safe harbor as well as some distinctions presumably based on the differences between timber property and rental property.

Specifically, the safe harbor exception for timber property in section 857(b)(6)(D) provides that a sale of a "real estate asset" will not be classified as a prohibited transaction if it meets all of the following requirements:

> 1) the REIT held the property for at least two[20] years in connection with the trade or business of producing timber;
>
> 2) capital expenditures (other than timberland acquisition expenditures) that are directly related to the operation of the property for the production of timber or the preservation of the property for use as timberland and that the REIT made to the property during the two years preceding the date of sale do not exceed 30%[21] of the property's net selling price (30% Timber Rule);

---

[19] The legislative history to the 86 Act does note that "[t]he 100 percent tax on prohibited transactions tax ensures that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project." S. Rep. No. 313, 99th Cong., 2d Sess. 771 (1986).

[20] The RIDEA provisions also shortened the original Timber Property Safe Harbor holding period from four years to two years.

[21] The legislative history provides that "[c]apital expenditures counted towards the 30-percent limit are those expenditures that are includible in the basis of the property (other than timberland acquisition expenditures), and that are directly related to operation of the property for the production of timber, or for the preservation of the property for use as timberland. These capital expenditures are those incurred directly in the operation of raising timber (i.e., silviculture), as opposed to capital expenditures incurred in the ownership of undeveloped land. In general, these capital expenditures incurred directly in the operation of raising timber include capital expenditures incurred by the REIT to create an established stand of growing trees. A stand of trees is considered established when a target stand exhibits the expected growing rate and is free of non-target competition (e.g., hardwoods, grasses, brush, etc.) that may significantly inhibit or threaten the target stand survival. The costs commonly incurred during stand establishment are: (1) site preparation including manual or mechanical scarification, manual or mechanical cutting, disking, bedding, shearing, raking, piling, broadcast and windrow/pile burning (including slash disposal costs as required for stand establishment); (2) site regeneration including manual or mechanical hardwood coppice; (3) chemical application via aerial or ground to eliminate or reduce vegetation; (4) nursery operating costs including personnel salaries and benefits, facilities costs, cone collection and seed extraction, and other costs directly attributable to the nursery operations (to the extent such costs are allocable to seedlings used by the REIT); (5) seedlings including storage, transportation and handling equipment; (6) direct planting of seedlings; and (7) initial stand fertilization, up through stand establishment. Other examples of capital expenditures incurred directly in the operation of raising timber include construction cost of road to be used for managing the timber land (including for removal of logs or fire protection), environmental costs (i.e., habitat conservation plans), and any other post stand

> 3) capital expenditures that the REIT made to the property during the preceding two years (other than timberland acquisition expenditures) that are not directly related to the operation of the property for the production of timber or the preservation of the property for use as timberland do not exceed 5%[22] of the net selling price of the property (the 5% Timber Rule);
>
> 4) a) the REIT satisfies the same Seven Sales Rule applicable in the case of the Rental Property Safe Harbor, or, if not, b) the REIT satisfies the same 10% Rule applicable in the case of the Rental Property Safe Harbor; and,
>
> 5) if the REIT is relying on the 10% Rule, substantially all of the marketing expenditures were made through an independent contractor, from whom the REIT receives no income, or, for sales generally before December 31, 2009, from a TRS (the Timber Marketing Rule).

Thus, the Timber Property Safe Harbor differs from the Rental Property Safe Harbor in a number of respects. First, it requires that the property be held for the production of timber. Second, the Timber Property Safe Harbor limits to 5% the capital expenditures that can be incurred to change the use of the property from timber-related to another use.

Third, the Timber Marketing Rule is itself different in two ways from the Rental Marketing Rule. To begin with, it does not require that substantially all of the development expenditures with respect to a property be made through an independent contractor from whom the REIT receives no income. It permits the REIT to undertake development activities, but limits expenses undertaken in the two years preceding sale by means of the 30% Timber Rule and the 5% Timber Rule. Like the Rental Marketing Rule, the Timber Marketing Rule does require that substantially all of the marketing expenditures with respect to a particular property be made through an independent contractor from whom the REIT receives no income. However, as a refinement to the Rental Marketing Rule, and as a result of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-234, the timber safe harbor temporarily allows the TRSs of timber REITs also to provide marketing services (for most timber REITs, ending on December 31, 2009).

---

establishment capital costs (e.g., 'mid-term fertilization costs')." H.R. Rep. No. 755, 108th Cong., 2d Sess. 324 (2004).

[22] The legislative history provides that "[c]apital expenditures counted towards the five-percent limit are those capital expenditures incurred in the ownership of undeveloped land that are not incurred in the direct operation of raising timber (i.e., silviculture). This category of capital expenditures includes: (1) expenditures to separate the REIT's holdings of land into separate parcels; (2) costs of granting leases or easements to cable, cellular or similar companies; (3) costs in determining the presence or quality of minerals located on the land; (4) costs incurred to defend changes in law that would limit future use of the land by the REIT or a purchaser from the REIT; (5) costs incurred to determine alternative uses of the land (e.g., recreational use); and (6) development costs of the property incurred by the REIT (e.g., engineering, surveying, legal, permit, consulting, road construction, utilities, and other development costs for use other than to grow timber)." *Id.* at 324-25 (2004).

c. ***Like the Timber Marketing Rule, the Rental Marketing Rule Should Not Require Substantially All of the Development Expenditures to be Made Through an Independent Contractor***

Unlike the Timber Marketing Rule, the Rental Marketing Rule also denies a REIT the use of the prohibited transactions safe harbor unless the REIT uses an independent contractor to develop a property. Again, there is no legislative history to assess the purpose of this provision, but we believe that it should be repealed for two reasons.

First, development for one's own long-term investment does not cause one to become a dealer under section 1221(a)(1). *See Cottle v. Commissioner*, 89 T.C. 467 (1987). (In holding that the taxpayer did not hold property primarily for sale to customers in the ordinary course of any trade or business, the Tax Court noted that, among other things, the taxpayer acquired the property as part of a plan to acquire, renovate and refurbish, and operate rental properties for its own use, not to enhance salability, but to enhance rentability. Furthermore, taxpayer sold when conditions changed, but only after he had lost the control he believed he needed in order to manage the rental operations.) Therefore, a REIT should not have to "outsource" such activities to either an independent contractor or a TRS. In many economic cycles, a real estate owner can acquire a real estate asset at substantially less cost by developing it itself rather than acquiring it from a third party. Not allowing a REIT to avail itself of the dealer sales safe harbor to the extent that it develops a real estate asset for its own use would deprive REITs and their shareholders from an important tool to for the creation of long-term value.

Second, the inclusion of development costs in the Rental Marketing Rule appears unnecessary because of the 30% Rule listed above, which denies the safe harbor if a REIT's expenditures includible in a property's tax basis made within two years of the property's sale is at least 30% of that property's net sales price.[23] This rule is sensible because costs made in the two years before sale could well be considered made in preparation of a sale, and, therefore, evidence of intent to act as a dealer. Since development costs are includible in a property's tax basis,[24] such costs are covered by the 30% rule and should not be separately covered by the Rental Marketing Rule.

Accordingly, NAREIT recommends that the Rental Marketing Rule be conformed to the Timber Marketing Rule and limited to marketing expenses, with development expenses covered only by the 30% Rule (and, in the case of the Timber Marketing Rule, by the 5% Rule for property being converted from use as timberlands).

---

[23] Section 857 (b)(6)(C)(ii) and (D)(ii).

[24] Section 263A requires the capitalization of direct and indirect costs properly allocable to real property and tangible personal property "produced" by a taxpayer. Section 263A(a) and (b). Section 263A(g)(1) defines the term "produce" as including "construct, build, install, manufacture, develop, or improve." Treas. Reg. § 1.263A-1(a)(3)(ii) provides that taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs, regardless of whether the property is sold or is used in the taxpayer's trade or business. Treas. Reg. § 1.263A-1(d)(1) provides that self-constructed assets are assets produced by a taxpayer for use by the taxpayer in its trade or business. Therefore, the costs incurred in developing real property for a taxpayer's own use in its trade or business are subject to section 263A.

d. *Both Rental Marketing Rule and Timber Marketing Rule Should Permanently Allow Use of TRS to Provide Marketing Expenditures*

NAREIT also recommends that the Rental Marketing Rule be conformed to the current Timber Marketing Rule to allow a TRS to provide marketing services on behalf of a REIT without jeopardizing the REIT's use of the dealer sales safe harbor.[25] Furthermore, this provision should be made permanent. A TRS is an entity separate and apart from a REIT. It is fully subject to a corporate level of tax (something that is not necessarily true for an independent contactor) and is not prohibited from conducting marketing services.

We note that allowing a TRS to provide such services (as opposed to the current law's requirement that only an independent contractor must be used) would enable a REIT to conserve cash when it makes an asset sale, thereby generating a greater amount of net capital from an asset sale that could be used to reduce debt or invest appropriately.

B. Expand Foreclosure Property Grace Period Termination Rule to Allow TRS to Operate Foreclosed Property

Although REITs may plan to hold property and/or mortgages secured by property for the long term, there may be times, such as those the country is experiencing currently, when a REIT is forced to foreclose on a mortgage and thereby acquires the property secured by that mortgage. In such case, absent special rules, the REIT could be faced with non-qualifying income from such property that could jeopardize its REIT status. Similarly, sale of property acquired shortly after foreclosure could be viewed as a prohibited transaction the gain from which would be subject to a 100% prohibited transactions tax.

To avoid this result, a REIT is permitted to make a foreclosure property election with respect to certain property acquired through foreclosure. However, the election does have a limited effective period. Under section 856(e)(2), property generally ceases to be foreclosure property as of the close of the third taxable year following the taxable year in which the REIT acquired such property, although extensions may be available. Furthermore, section 856(e)(4) terminates a foreclosure property election 90 days after a REIT's acquisition of the property if used in a trade or business conducted by the REIT "(other than through an independent contractor . . . from whom the [REIT] itself does not derive or receive any income)."

Again, section 856(e)(4) was in force prior to the enactment of the TRS rules. As with the Marketing Rule discussed above, prior to the advent of TRSs, it is understandable that the

[25] Just as the RMA expanded section 856(d)(7)(C) to provide that services will not be treated as furnished by the REIT if provided through *either* an independent contractor from whom the REIT derives no income *or* a TRS, NAREIT recommends expanding sections 857(b)(6)(C)(v) and 857(b)(6)(D)(v) to provide that substantially all of the expenditures under those sections with respect to the sold property could be provided by an independent contractor from whom the REIT receives no income *or* from a TRS. The Food, Conservation and Energy Act of 2008, Pub. L. No. 110-234, did expand section 857(b)(6)(C)(v) to allow the TRSs of timber REITs to provide these activities for a one-year period (for most taxpayers, ending on December 31, 2009).

foreclosure property election terminate some reasonable period of time after the REIT begins to use the relevant property in a trade or business unless through an independent contractor. However, since the policy behind the authorization of the TRS vehicle was to allow TRSs to undertake virtually any activity (including the operation of a business, the gain with respect to which would be subject to tax at the corporate level), this rule also should be modernized to allow *either* an independent contractor from whom the REIT receives no income or a TRS to operate foreclosure property without risk of terminating the foreclosure property election.

There also may be situations in which a REIT acquires an operating business through foreclosure and, as a result of geographic or market forces, is unable to locate an independent contractor to operate the business. In such case, allowing a REIT to use a TRS to operate the business (the income from which would be subject to tax) could provide assistance to REITs that are forced to foreclose in the current economic climate in satisfying the REIT gross income tests and avoiding the 100% prohibited transactions tax.

C. Clarify the Dealer Sales Safe Harbor so that it Applies Only to Sales of "Real Property" and "Interests in Real Property"

As noted above, a 100% prohibited transactions tax applies to gain from the sale or disposition of "property" described in section 1221(a)(1) that is not foreclosure property. However, a safe harbor applies to the sale of a "real estate asset" if certain conditions are met. Included in those conditions are satisfaction of both the Seven Sales Rule and the 10% Rule, described above. Both of these rules refer to the sale of "property," not "real estate assets."

Thus, if a REIT were to sell seven units of measurement of any property (*e.g.*, if a REIT were to sell seven refrigerators from an apartment building it was renovating), it might arguably fail the Seven Sales test, causing it to have to comply with the additional provisions of the 10% Rule (*e.g.*, use of an independent contractor for marketing and development expenses). Further, if it were to sell seven non-real estate assets with a significant value or basis (*e.g.*, this could occur if the REIT acquires an entity with a large real estate portfolio and a significant amount of non-real estate, with the plan to retain the real estate and quickly sell off the non-real estate since it is not part of its core business even if it sells the non-real estate without realizing a gain), the result might be a failure of the 10% Rule as well.

It does not seem appropriate for the sale of non-real estate assets to affect the treatment of a REIT as a dealer with respect to the sale of its real estate assets. Specifically, if a REIT were to make a number of sales of non-real estate assets, these sales should not cause the REIT to fail the safe harbor with respect to a subsequent sale of a parcel of real property. Similarly, sales by the REIT of stock or debt securities in other qualifying REITs should not cause the selling REIT to fail to satisfy the safe harbor with respect to a subsequent sale of a parcel of real property because the two assets are sufficiently dissimilar.

As a result, NAREIT recommends that the prohibited transactions safe harbors in sections 857(b)(6)(C)(iii) and 857(b)(6)(D)(iv) be amended so that they apply to sales of real property and "interests in real property" and that only sales of real property and "interests in real

property" are taken into account for purposes of the Seven Sales Test and the 10% Rule.[26] The reason for this clarification is to be more consistent with existing authority regarding the status of a taxpayer as an investor vs. dealer in real property, in that activities of the taxpayer relating to trading in securities (even real estate-related securities) generally would not be taken into account for purposes of determining whether the taxpayer is a dealer or investor with respect to real property or "interests in real property."

V. AUTHORIZE PASS-THROUGH OF ENERGY TAX CREDITS TO SHAREHOLDERS

The Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, added section 54A(h) to the Code. This provision allows mutual funds and REITs to pass through tax credits with respect to qualified tax credit bonds to shareholders. The American Recovery and Reinvestment Act of 2009 (ARRA) later included a provision specifying the mechanics for the pass-through of these credits to mutual fund shareholders. Although ARRA did not address the mechanics for the pass-through of these credits to REIT shareholders, it continued to authorize the Treasury Department to address this issue in regulations. Qualified tax credit bonds are bonds in which Congress permits holders to receive a tax credit in lieu of interest from the borrower. Because REITs and mutual funds typically have no tax liability against which to offset these tax credits, the Code permits them to pass through these tax credits to their shareholders.

Especially in the energy area, Congress uses credits and grants in lieu of credits to encourage investments in activities intended to provide societal benefits. The fundamental trade-off that Congress has established for almost 50 years is that, in exchange for no corporate level tax on a REIT, REIT shareholders become subject to tax on mandatory REIT distributions. Passing tax credits on to REIT shareholders who bear the tax of the REIT enterprise would more clearly match the benefits and burdens of the REIT shareholders.

Based on the precedent already existing in the qualified tax credit bond area, NAREIT recommends the pass-through of any credits in energy legislation that Congress considers in the future, especially in the "cap and trade" legislation that Congress is currently considering. "Buildings" account for 40% of all energy use and almost 70% of all electrical energy use in the U.S. To remain consistent with congressional policy to grow the U.S. economy, reduce the reliance on foreign energy, and enhance the use of renewable energy in the U.S., we request this legislation be drafted in a manner most likely to encourage REITs and other taxpayers to invest in renewable energy projects—without limitation based on their ultimate tax liability.

---

[26] The IRS concluded as much in PLR 9308013, in which it stated "it is clear that the term 'property' in section 857(b)(6)(C)(iii) of the Code refers only to real property and not personal property such as [the property at issue in the ruling]." PLR 9308013 also noted that

> [t]he legislative history of the safe harbor exception, which was enacted as part of the Revenue Act of l978, Pub. L. No. 95-600, 1978-3 (Vol. 1) C.B. 1, lends further support to the conclusion that the seven sales rule (five sales at the time of enactment) is only applicable to real property. It states that "[w]ith regard to the not more than five sales per year rule, the sale of more than one property to one buyer as part of one transaction is to be treated as one sale. For this purpose, the properties need not be contiguous or located near each other." S. Rep. No. 1263, 95th Cong., 2d Sess., 178 (1978), 1978-3 C.B. (Vol. 3) 178, 179.

Specifically, in order to encourage REITs to undertake energy efficiency projects, these credits should be available without regard to section 50(d)(1) so that the amount of the credit is not limited to the amount of taxable income retained by the REIT.[27] Otherwise, the congressional incentives to stimulate the economy in a sustainable manner would not be available to a significant segment of the commercial real estate industry well suited to deploy these new technologies.

As a corollary to this recommendation, a foreign REIT shareholder should be entitled to claim a refund of withholding taxes against any credit allocated to it. Finally, if the issue discussed above concerning the potential for preferential dividends as a result of minor errors has not been resolved, we recommend that any reasonable allocation of credits among shareholders of different classes of stock not be considered preferential so long as they are consistent with the applicable charter documents.

VI. TREAT REIT DEBT SECURITIES AS "REAL ESTATE ASSETS" IN THE SAME MANNER AS REAL ESTATE EQUITY SECURITIES

Under section 856(c)(4)(A), at least 75% of a REIT's assets quarterly must be "real estate assets." Section 856(c)(5)(B) includes in the definition of "real estate assets" "shares (or transferable certificates of beneficial interest) in other [REITs] which meet the requirements of this part." Thus, equity interests in qualifying REITs are treated as real estate assets. This treatment is consistent with the policy rationale underlying REITs because the many rules that restrict a REIT's activities and income to commercial real estate ensure that REIT stock is inextricably connected to real estate.

REIT equity securities have been included in the definition of "real estate assets" since 1960, when Congress first authorized REITs as a way in which ordinary investors can access the benefits of owning interests in large-scale commercial real estate. At the time and for several decades, REITs did not issue significant amounts of unsecured debt. The issuance of REIT unsecured debt was so infrequent that NAREIT did not keep track of debt issuances until 1991. Over time, however, the REIT industry has grown, and unsecured debt has become more common. As can be seen in Exhibit B, the use of unsecured debt has grown substantially since then. Access to the unsecured debt markets has proven to be particularly useful in times like today, when access to the secured debt market is constrained.

Like distributions on REIT shares, interest payments on REIT unsecured debt are derived from the underlying REIT's qualifying REIT income. Furthermore, since debt securities have a higher priority than equity securities, holders of REIT debt securities have an even greater claim on the underlying REIT's assets than do REIT equity holders.[28] As a result, debt securities of qualifying

[27] NAREIT also recommends that any legislation that provides for "grants in lieu of credits," such as Section 1603 of ARRA, be similarly available to REITs and their shareholders without regard to the amount of taxable income retained by the REIT.

[28] Because unsecured REIT debt is not a real estate asset, a REIT could lose its REIT status if the debt securities it owned in another REIT amounted to more than 5% of value of the first REIT's assets under section 856(c)(4)(B)(iii)(I) (or if REIT debt, along with other non-real estate assets exceeded 25% of the value of the

REITs similarly should be considered "real estate assets." This change would rationalize the REIT tax rules with how the industry has evolved from its beginnings.

VII. MAKE PERMANENT AND EXTEND TO ALL REITS THE TREATMENT OF MINERAL ROYALTIES AS QUALIFYING REIT INCOME UNDER SECTION 856(c)(2)

Section 856(c)(2)(I) treats as qualifying income under the 95% gross income test "mineral royalty income earned in the first taxable year beginning after the date of the enactment of this subparagraph from real property owned by a timber real estate investment trust and held, or once held, in connection with the trade or business of producing timber by such real estate investment trust." This provision was added on a temporary basis by the Food, Conservation and Energy Act of 2008, and it expires in general at the end of 2009.[29]

NAREIT recommends that this provision be made permanent and expanded beyond timber REITs to apply to any REIT. In addition, legislation should clarify that the term "mineral royalty income" includes oil and gas royalties. While the term "mineral royalty income" is not defined, the terms "mineral royalties" or "mineral leases" generally include royalties and/or leases for all types of minerals, including oil and gas.[30] Further, had Congress wanted to exclude oil and gas royalty income from the definition of "mineral royalty income," it could have done so specifically.[31] Nevertheless, any extension of this provision should resolve any uncertainty that "mineral royalty income" includes oil and gas royalties.

REIT's total assets). Although there is a general rule in section 856(c)(4)(B)(iii)(III) that a REIT may not own more than 10% of the value of any issuer's securities, section 856(m)(1)(F) was added in 2004 so that any securities in another REIT were not counted for this purpose.

[29] Note that this provision did not change the general rule of section 856(c)(5)(C) that "mineral, oil, or gas royalty interests" are not "interests in real property" for purposes of the REIT asset tests. The Food, Conservation and Energy Act of 2008 also defined the term timber real estate investment trust as a REIT in which "more than 50 percent in value of its total assets consist of real property held in connection with the trade or business of producing timber." This definition also expires at the end of 2009.

[30] *See* section 263A(c)(3) (excepting from the general capitalization rules of section 263A certain "development and other costs of oil and gas wells or **other mineral property**"); sections 614(a) ("For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land) and (b) (special rules for computing the depletion allowance for mineral interests **specifically** in oil and gas wells or geothermal deposits); Treas. Reg. § 1.611-1(d)(5) (for purposes of the deduction for depletion, the term "[m]inerals **includes ores of the metals, coal, oil, gas**, and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources.") (Emphasis added); Rev. Rul. 94-48, 1994-2 C.B. 3 (concerning a "mineral property" that produces "qualified fuel" under section 29, including gas).

[31] *See* section 613(a)(7)(C) (specifically excluding from the term 'all other minerals' "oil and gas wells" presumably, therefore, oil and gas wells would be included in the definition of "all other minerals" unless specifically excluded).

Furthermore, because mineral royalty income represents passive income,[32] there is no policy reason as to why it should not be included as qualifying income under section 856(c)(2) for both timber REITs and other REITs, so long as the core business of both types of REITs remains respectively either holding property for the production of timber or for the production of rental income.[33] In fact, the purpose of the proposal is to address the issues for legitimate REITs in dealing with minerals which happen to be on the real estate owned by the REITs, not to encourage oil companies to become taxable as REITs.

To ensure that any such royalty income earned by a REIT be incidental to the REIT's business of renting property and/or owning timber, we suggest that the royalty income must be earned from real property owned by a REIT and held, or once held, in connection with the trade or business of producing timber or receiving rental income by such REIT. We believe this is consistent with Congressional intent.

VIII. TREAT PERSONAL PROPERTY ASSOCIATED WITH REAL PROPERTY AS A REAL ESTATE ASSET IF IT AMOUNTS TO LESS THAN 15% OF SUCH REAL PROPERTY

Under section 856(c)(4)(A), at least 75% of the value of a REIT's assets quarterly must be from "real estate assets," cash, cash items, and government securities. Current law does not treat personal property leased in connection with real estate as a real estate asset for purposes of this asset test.[34] Conversely, for purposes of the income test,[35] rent attributable to personal property that is leased under, or in connection with, a lease of real property, is treated as qualifying rents from real property so long as the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.[36] An example of this rule is furniture included in the lease space of an office building.

---

[32] *See* Patrick A. Hennessee, *Oil and Gas, Federal Income Taxation* section 105.04 (2003) ("A royalty interest is the right to receive a specified amount of the gross income or production from a mineral property. The amount may be expressed as a fraction or percentage of total production. In some cases, it may be expressed as a specific amount per unit. A royalty owner is ordinarily liable for his share of production or severance taxes, but not for the costs of exploration, development, or operation. A royalty interest is therefore a nonoperating interest for federal income tax purposes."); *See also* Treas. Reg. § 1.614-2(b) which defines an "operating mineral interest" and specifically excludes royalty or similar interests and Treas. Reg. § 1.512(b)-1(b) which provides that mineral royalty income is excluded from the computation of unrelated business taxable income.

[33] *Cf.* the dealer sales safe harbors which impose similar requirements in section 857(b)(6)(C)(iv) (disposed property must have been held for not less than two years for the production of rental income) and section 857(b)(6)(D)(i) (disposed property must have been held not less than two years in connection with the trade or business of producing timber).

[34] *See* Treas. Reg. § 1.856-3(d).

[35] Section 856(d)(1)(C).

[36] *See also* Treas. Reg. § 1.1031(k)-1(c)(5) (for purposes of applying the rule for deferred like kind exchanges that replacement property be identified within the applicable time period, treating "incidental property" as part of larger property if the incidental property is typically transferred with such larger property and "the aggregate fair market value of all of the incidental property does not exceed 15[%] of the aggregate fair market value of the larger item of property").

Just as personal property that is an integral part of the associated real property can generate qualifying rental income, personal property that is an integral part of the associated real property should be considered a qualifying real estate asset for purposes of the 75% asset test of section 856(c)(4)(A). Accordingly, NAREIT recommends that this test be modified so that personal property be treated as a real estate asset if it is leased under, or in connection with, the lease of real property, and the value of the personal property does not exceed 15% of the total value of such real property (based on either fair market value or adjusted tax basis).

IX. REDUCE THE REIT REAL ESTATE AND PASSIVE INCOME TEST FROM 95% TO 90%

Section 856(c)(3) requires that at least 75% of a REIT's gross income be from real estate-related sources. Section 856(c)(2) requires that at least 95% of a REIT's gross income be from sources qualifying under section 856(c)(2), as well as certain other passive sources, such as non-real estate-related dividends and interest.

On the other hand, the gross income test under section 851(b)(2) for mutual funds requires that 90% of their gross income be derived from qualifying sources. Congress last modified section 856(c)(2) in 1976 (effective for tax years beginning after January 1, 1980) to increase the gross income test in that section from 90% to 95% of gross income. At the time, Congress also amended the Code to allow a REIT to pay a tax if it failed to meet the gross income tests and also expanded the type of income that could be considered qualifying income under section 856(c)(2).

Nevertheless, the REIT industry has evolved significantly since 1976. Not only that, but the current economic crisis has resulted in non-performing loans and more tenant bankruptcies as well as the need to retain capital and locate new sources of capital, particularly since REITs must distribute at least 90% of their REIT taxable income annually.

Consistent with the gross income test requirement for mutual funds, NAREIT recommends returning the section 856(c)(2) gross income test to a requirement that 90% of a REIT's annual gross income consist of passive sources. This change would reduce the number of inadvertent errors, and it also would allow REITs to provide greater security during tumultuous market conditions.

X. MODIFY HEDGING RULE OF SECTION 856(c)(5)(G) TO COVER HEDGES ENTERED INTO TO COVER ANOTHER HEDGE

A. Background

Section 856(c)(5)(G)(i) contains a rule that permits certain types of income from hedging to constitute qualifying REIT income under both sections 856(c)(2) and (c)(3). Specifically, section 856(c)(5)(G)(i) provides that:

> any income of a real estate investment trust from a hedging transaction (as defined in clause (ii) or (iii) of section 1221(b)(2)(A)) which is clearly identified pursuant to section 1221(a)(7), including gain from the sale or disposition of such a transaction, shall not constitute gross income under paragraphs (2) and (3) to the extent that the transaction hedges any indebtedness incurred or to be incurred by the trust to acquire or carry real estate assets.

B. Issue: Hedges to Counteract Qualifying Hedges Can Result in Non-Qualifying Income

Although section 856(c)(5)(G)(i) is generally a helpful provision, we have identified one specific issue with its application that should be addressed. Specifically, under section 856(c)(5)(G)(i), a hedge entered into to counteract another hedge is not treated as a qualifying hedge (despite the fact that such counteracting hedge does qualify under section 1221 pursuant to Treas. Reg. § 1.1221-2(d)(3)) in the following fact pattern.

> Assume a REIT (REIT) is a borrower via an unsecured loan, the interest on which is variable. Such unsecured loan (like all other loans of the REIT) was incurred to acquire or carry real estate assets. REIT hedged the interest expense exposure on the unsecured loan by entering into a fixed pay interest rate swap in compliance with section 856(c)(5)(G)(i) (the Original Hedge). In the current credit environment, REIT cannot refinance the unsecured loan. As a result, it obtains fixed rate mortgage financing and uses the proceeds to repay the unsecured loan.
>
> After repayment of the unsecured loan, the Original Hedge remains in place, thus causing the REIT to be over hedged. In order to manage its interest rate risk, REIT corrects such over hedge position using an approach which is customarily used in such situations—to enter into a counteracting variable pay swap (the Counteracting Hedge) with a notional principal amount equal to that of the Original Hedge.

Under existing law, REIT's Original Hedge is no longer a qualifying hedge under section 856(c)(5)(G)(i) as it no longer hedges debt incurred to acquire or carry real estate assets (as the hedged debt was repaid). Further, there is a possibility that the Counteracting Hedge is not a qualifying hedge as it was entered into to counteract the Original Hedge (and as such, arguably does not hedge debt incurred to acquire or carry real estate assets). This is the case despite the fact that the Counteracting Hedge is, pursuant to Treas. Reg. § 1.1221-2(d)(3), treated as a hedging transaction under section 1221(b)(2)(A)(ii) or (iii) provided the identification requirements are satisfied.

To remedy this unfair result, we recommend that section 856(c)(5)(G)(i) be revised to provide that, when a hedge that qualified under section 856(c)(5)(G)(i) is counteracted by another hedge, which pursuant to Treas. Reg. § 1.1221-2(d)(3) is treated as a hedging transaction under section 1221(b)(2)(A)(ii) or (iii), both such hedging transaction are treated under section 856(c)(5)(G)(i) as qualifying hedges, provided that such counteracting hedge is properly identified under section 1221.

XI. PERMANENTLY CODIFY TREATMENT OF TIMBER GAINS UNDER SECTIONS 631(a) AND (b) AS QUALIFYING REIT INCOME UNDER SECTIONS 856(c)(2) AND (c)(3)

By way of background, section 631(a) allows a taxpayer who owns, or has a contract right to cut, timber to elect to treat the cutting of timber as a sale or exchange of the timber in the year the timber is cut, provided the timber or the contract right to cut the timber is held for more than one year.

Similarly, section 631(b) treats certain disposals of timber held for more than one year as a sale or exchange of the timber if the taxpayer either retains an "economic interest" in the standing timber or makes an outright sale of such timber (*e.g.*, by timber deed). An "economic interest" in the standing timber is retained by a taxpayer if the amount of the payment for the timber depends solely on the actual quantity of timber cut. One mechanism for accomplishing this treatment is through a "pay-as-cut contract" because under such a contract, the taxpayer is paid only for the timber that is cut and title to the timber passes upon severance of the timber from the underlying land. Several private letter rulings have ruled that gain recognized under section 631(b) is properly treated as qualifying REIT income under sections 856(c)(2)(D) and (c)(3)(C). *See, e.g.*, PLRs 200052021, 199945055, 199927021, 199925015, and 8838016.

Section 856(c)(5)(H) as passed under the Food, Conservation and Energy Act of 2008 temporarily treats gain attributable to timber under <u>both</u> sections 631(a) or (b) (and income which would constitute such gain but for the failure to satisfy the 12 month holding period requirement of section 631) as qualifying REIT income under sections 856(c)(2)(D) and (c)(3)(C) (generally through the end of 2009). This provision codified the holdings of the rulings mentioned above and creates a framework for treating section 631(a) income as qualifying REIT income. The legislative history to this provision also noted that "[t]imber income under section 631(b) has also been held to be qualified real estate income even if the one year holding period is not met. *See, e.g.*, PLR 200052021, *see also* PLR 199945055, PLR 199927021, PLR 8838016." H.R. Rep. No. 627, 110th Cong., 2d Sess. 1037, fn 16.

NAREIT recommends that these provisions be extended permanently.

XII. CONFIRM THAT "CARBON CREDITS" WILL CONSTITUTE QUALIFYING REIT ASSETS, AND INCOME FROM SALES OF "CARBON CREDITS" WILL GENERATE QUALIFYING REIT INCOME AND NOT DEALER SALES INCOME

Recently, Congress has been considering energy-related legislation with the goal of reducing global warming. It is believed that one way to achieve this goal is through "carbon sequestration," that is, the removal of carbon dioxide from the atmosphere.

As trees grow, they remove or "sequester" carbon dioxide from the atmosphere.[37] As a result, increased tree planting (and growing) is viewed as a mechanism to reduce global warming. To encourage tree planting (and growing) and other activities that remove carbon from the atmosphere, there are now markets for "carbon credits" (also called "carbon offsets"). A carbon credit is a mechanism through which a purchaser pays another party to remove a certain quantity of carbon dioxide from the atmosphere and in effect compensate for the purchaser's emission of carbon dioxide. With regard to carbon sequestration via trees, the forest owner could effectively sell/rent the carbon-sequestering ability of a unit of timber for a certain period of time to the individual who buys the carbon credit.

A market for trading carbon credits exists in the European Union[38] and may soon exist in New Zealand.[39] In the United States, although Congress has not yet enacted a "cap and trade" system, the Chicago Climate Exchange (CCX) is an institution that "operates North America's only cap and trade system for all six greenhouse gases, with global affiliates and projects worldwide. CCX emitting Members make a voluntary but legally binding commitment to meet annual [greenhouse gas] emission reduction targets. Those who reduce below the targets have surplus allowances to sell or bank; those who emit above the targets comply by purchasing CCX Carbon Financial Instrument® (CFI®) contracts."[40]

Timber REITs own millions of acres of timberlands across the U.S.[41] The treatment of carbon credits for REIT tax purposes is currently unclear. Until it is clarified, timber REITs may be hesitant to enter any markets for exchanging carbon credits.

As Congress considers "cap and trade" legislation which may allow for the ability to trade carbon credits, it is important to consider the tax consequences to REITs, particularly timber REITs, so that these entities are encouraged to undertake more tree planting (and growing) consistent with the goals of the legislation. Specifically, NAREIT recommends the following:

> 1) carbon credits should be viewed as qualifying real estate assets inextricably linked with the underlying real estate;[42]
>
> 2) income from the sale of carbon credits should be considered qualifying REIT income under sections 856(c)(2) and (c)(3);[43] and,

---

[37] http://www.epa.gov/sequestration/faq.html.
[38] http://ec.europa.eu/environment/climat/emission/index_en.htm.
[39] http://www.climatechange.govt.nz/emissions-trading-scheme/ets-diagram.html . *See also* Kyoto Protocol, http://unfccc.int/kyoto_protocol/items/3145.php (allowing for similar market).
[40] http://www.chicagoclimatex.com.
[41] Branching Out: Distinctive Features Might Allow for Timber REITs, [http://www.realestateportfolio.com/portfoliomag/06novdec/feat6.shtml].
[42] The IRS has held that trees constitute "real estate assets." *See* PLR 200052021. Furthermore, the IRS has held that real estate intangibles like goodwill constitute "real estate assets" if inextricably linked to the underlying real estate *See* PLR 200813009. Consistent with the analysis in PLR 200813009, NAREIT recommends that in order to avoid any confusion on the matter, Congress clarify that carbon credits or the ability to sequester carbon are inextricably linked with the underlying real estate, and do not constitute assets separate from the underlying timberland, and, therefore, constitute "real estate assets."

3) gain from the sale of carbon credits should not be subject to the prohibited transaction rules.[44]

****

We hope that we can meet later this month to discuss these proposals in more detail. Please call me at (202) 739-9408 or Dara Bernstein, NAREIT's Senior Tax Counsel, at (202) 739-9446.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

Attachments

[43] While Section 856(c)(5)(J) provides the IRS the authority to determine whether any item of income or gain that does not otherwise qualify under the REIT income tests may be considered as not constituting gross income for purposes of these tests, legislative clarification is preferred as Congress considers the cap and trade or similar legislation.

[44] Instead, carbon credits income should be analogized to the income received from renting trees: the purchaser of the credit obtains over a specified period of time the right to enjoy the benefit of one aspect of the property, akin to a kind of easement. If income from the sale of carbon credits were subject to the 100% tax on dealer sales, the purpose of encouraging additional tree planting would be defeated. While the discussion above relates specifically to carbon credits, we would assume a similar analysis would apply to similar types of incentives to engage in environmentally conscious activities. For example, we recommend that any grants to taxpayers to improve the energy efficiency of property be treated as qualifying REIT assets. Further, to the extent included in gross income, such income should be qualifying REIT income.

EXHIBIT A

PROPOSED MODIFICATION TO "REASONABLE CAUSE" REQUIREMENT WITH INCREASED PENALTIES AND INTEREST IN "REIT SAVINGS" PROVISIONS

I. BACKGROUND

A. Current Law

There are numerous so-called "death trap" provisions in the REIT rules, a violation of which results in the disqualification of the REIT. Naturally, REIT managers expend significant resources to avoid such a drastic result. In 2004, Congress enacted the REIT Improvement Act, which included certain provisions that built in some flexibility to the REIT tax rules and imposed monetary penalties, in lieu of REIT disqualification, for the failure to meet certain REIT rules when there was reasonable cause for the failure (the REIT Savings provisions).

More specifically, the REIT Savings provisions generally allow a REIT to avoid loss of REIT status due to the failure to satisfy the REIT asset tests under section 856(c)(4), income tests under sections 856(c)(2) and (3), or "other" REIT requirements under section 856(g) by remedying the failure and paying a monetary penalty.[45] However, this option is only available if the failure is due to "reasonable cause and not willful neglect."

B. Issue

Because the determination of this issue is so factual, and there is virtually no guidance which applies this standard in the context of a REIT, it is frequently difficult for both taxpayers and the IRS to conclude with certainty that any REIT test failure is due to reasonable cause and not willful neglect. In addition, many technical failures are due to inadvertence; loss of REIT status in those circumstances would be grossly disproportionate to the technical nature of the violation. Further, the time spent both by the government and taxpayers on closing agreements to resolve these issues is significant and inefficient.

C. Proposal

Accordingly, NAREIT proposes legislative changes to the REIT Savings provisions that would provide relief from REIT disqualification for a REIT test failure when "reasonable cause and not willful neglect" cannot be demonstrated, provided that the failure is not due to the principal purpose of circumventing the REIT rules. When reasonable cause can be demonstrated, the current law penalty structure would apply, but the IRS would have an opportunity to review the self-assessment notice citing reasonable cause. It is anticipated that interested parties would work with the IRS to assist in the development of appropriate forms and procedures in order that, to

[45] Unless otherwise indicated, all section references are, to the Internal Revenue Code of 1986, as amended (the Code).

the extent possible, the changes proposed, including increased penalties in certain cases, be self-assessable without the need for taxpayers to seek advance closing agreements.

II. EXECUTIVE SUMMARY

In all three cases described below, the requirement that a REIT meet the "reasonable cause and not willful neglect" standard would be modified. For REITs that meet this standard, current law would continue to apply. For REITs that do not meet this standard, in many cases due to the difficulty in making such a demonstration with certainty, the increased penalties and procedures described below would apply. Furthermore, relief under the latter approach would not be available if the violation was the result of the principal purpose of circumventing one or more of the REIT test requirements. The ultimate penalty of de-REITing thus would be limited by the same standard that now applies to the loss of S corporation status as a result of the failure to meet the single class of stock requirement.[46]

A. Asset Test Failures

1. *"De Minimis" Asset Test Failures*

In order to measure non-material errors more accurately, NAREIT proposes modifying the definition of "*de minimis*" to comprise asset test failures under section 856(c)(4)(B)(iii) that are due to the ownership of assets the total value of which does not exceed the **greater** of 1% of the total value of the REIT's assets at the end of the quarter for which such measurement is done and $10 million. This change would make the asset test *de minimis* test more in line with the rental income *de minimis* test under section 856(d)(7)(B).

2. *Non-De Minimis Asset Test Failures*

For non-*de minimis* asset test failures, the current penalty is the greater of $50,000 or 100% of the income generated by the offending asset during the period in which the REIT held the nonqualifying asset and ending on the earlier of the date on which the REIT disposes of the nonqualifying asset or the REIT is otherwise in compliance with the asset test, multiplied by the highest corporate tax rate.

If a non-*de minimis* asset test failure of a REIT results from reasonable cause and not willful neglect, the current law penalty would be retained.

However, if the REIT does not have reasonable cause, this penalty would be increased to the greater of: a) $100,000; or, b) 110% of the income generated by the "bad" asset as multiplied by the highest corporate tax rate, plus interest on the latter amount accruing on such amount from the original due date of the tax return for the year in which the violation first occurred until the date of payment.

---

[46] *See* Treas. Reg. § 1.1361-1(l)(4)(ii)(2).

As under current law, the IRS would retain the ability to challenge on audit whether the asset failure was due to reasonable cause (if claimed) or to the principal purpose of circumventing the REIT rules.

B. Gross Income Test Failures

Again, if a REIT has reasonable cause and not willful neglect, the current penalty would be retained. However, if not, the current penalty of 100% of the amount by which the REIT failed either the 75% or 95% income test, as reduced by deductions allocable to such income, would be increased to 110% of such amount, plus interest from the due date of the tax until the date of payment.

C. "Other" Test Failures

If the REIT has failed a REIT test other than those described above, and it has reasonable cause and no willful neglect for such failure, the current penalty of $50,000 per failure would be retained.

If the REIT does not have reasonable cause for this reason, the penalty for "other" REIT test failures would be increased from $50,000 to $100,000 for the first such failure and some maximum, *e.g.,* $350,000 for any subsequent failures, plus interest from the original due date of the tax return applicable to the year in which the failure occurred until the date of payment. A continuing failure would be treated as a single failure, not as separate failures for each year in which the failure continued.

In response to an IRS request for the opportunity to review "other test" failures, our proposal would require the REIT to notify the IRS of an "other test" failure, and provide the IRS with an opportunity to review the notification in an expedited fashion. Specifically, the REIT would be required to notify the IRS of the existence of an "other test" failure within six months of discovery of the failure. The REIT also would be required to inform the IRS whether the failure was due to "reasonable cause," and, accordingly, the current law penalty structure would apply, or, if not, and the proposed higher penalty structure would apply. The IRS then would have 30 days to notify the REIT of its intent to review the REIT's notice.

If the IRS declined to review the notice, the REIT could self-assess at the appropriate penalty level, although the IRS always could challenge on audit whether the cause of the REIT's failure was due to the REIT's principal purpose of circumventing the REIT rules. If the IRS reviewed the notice, it would have an additional 90 days to determine whether the REIT had reasonable cause for the failure (if claimed by the REIT) or the REIT's failure was or was not attributable to the principal purpose of circumventing the REIT rules. The reason for this procedure is that, although the uncertainty in resolving whether the reasonable cause/not willful neglect standard has been met is the impetus for our proposal generally, there are some situations in which REITs may conclude that a REIT test failure is due to reasonable cause and not willful neglect. In those situations, the current law remedy and penalty would be retained, but the IRS would have the opportunity to challenge this conclusion on an expedited basis. As above, the IRS would retain

the ability to challenge on audit whether the particular failure was due to the principal purpose of circumventing the REIT rules.

D. Generally

The foregoing assumes that the REIT has not engaged in these actions or failures to take action due to a principal purpose to circumvent one or more provisions of the REIT tax rules. In the case of failures that relate to *de minimis* and/or "minor" errors resulting in a potentially preferential dividend, this proposal assumes that the IRS will issue adequate guidance that would prevent the loss of REIT status for "minor errors," as contemplated by item number 6 under Financial Institutions And Products (FI&P) of the IRS' 2008–2009 Priority Guidance Plan dated September 10, 2008, listing guidance providing relief for common errors that may affect qualification as a RIC or REIT. This has been on the Business Plan for two years.

Purely for consistency purposes, NAREIT proposes that the penalty provisions described above be re-situated to section 857, along with other penalty provisions.

III. REIT SAVINGS PROVISIONS IN DETAIL: CURRENT LAW AND PROPOSALS FOR CHANGE

As described further below, the RIA's "REIT Savings" provisions addressed three potential failures of the REIT rules:

1) asset test violations, including failures of the 10% vote or value tests of section 856(c)(4)(B)(iii)(II) and (III); the 5% value test of section 856(c)(4)(B)(iii)(I); the 20% TRS value test of section 856(c)(4)(B)(ii); the 75% value test of section 856(c)(4)(A); and the 25% value test of section 856(c)(4)(B);

2) failures of the 75% and 95% gross income tests of sections 856(c)(2) and (c)(3); and,

3) all other REIT test failures pursuant to which a REIT election would terminate under section 856(g)(5). These current "REIT Savings" provisions also are set forth below.

A. Asset Tests

1. *De Minimis Violations of the 5% and 10% Asset Tests*

a. ***Current Law***

Under current law, a REIT does not lose its REIT status for a *de minimis* failure of the 5% and 10% assets if the failure is due to the ownership of assets the total value of which does not exceed the lesser of: i) 1% of the total value of the REIT's assets at the end of the quarter for which such measurement is done; or, ii) $10 million. However, the REIT must either: i) dispose of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such other time period prescribed by the Treasury Department); or, ii) otherwise meet

the requirements of those rules by the end of such time period.[47] There is no requirement that the failure be due to "reasonable cause," and no monetary penalty applies.

b. ***Suggested Change***

Many REITs are large companies with billions of dollars in assets. Under the current *de minimis* test, however, any asset test violation in excess of $10 million would be viewed as non-*de minimis,* requiring the REIT to demonstrate reasonable cause even though, in relative terms, the violation may be far less than 1% of the REIT's assets.

Accordingly, in order more accurately to measure non-material errors, it is proposed to modify the definition of "*de minimis*" to comprise asset test failures under section 856(c)(4)(B)(iii) that are due to the ownership of assets the total value of which does not exceed the **greater** of: i) 1% of the total value of the REIT's assets at the end of the quarter for which such measurement is done; or, ii) $10 million. This change would be consistent with the policy underlying the 1% *de minimis* test for the definition in rents under section 856(d)(7)(B) that has worked well since 1997.

2. *Non-de minimis Asset Test Violations*

a. ***Current Law***

If a REIT fails to meet **any** of the asset test requirements for a particular quarter, and the failure exceeds the *de minimis* standard above, then the REIT will still be considered to have satisfied these tests if the REIT satisfies several requirements[48] as follows:

1) The REIT's failure to satisfy the particular asset test must be due to reasonable cause and not willful neglect;

2) The REIT must provide a schedule of the offending assets to the IRS and must dispose of these assets during a specified time period; and,

3) The REIT must pay a monetary penalty equal to the greater of: $50,000 or a tax (treated as an excise tax) computed by multiplying the highest corporate tax rate by the net income generated by the scheduled assets for the period beginning on the first date that the failure occurs and ending on the date when the REIT no longer fails to satisfy the particular asset test.

[47] Section 856(c)(7)(A).
[48] Section 856(c)(7)(B).

b. ***Suggested Change***

The present law rules would be retained for REITs that incur a non-*de minimis* asset test violation, when such violation is attributable to reasonable cause and not willful neglect. For failures when the REIT cannot demonstrate "reasonable cause and not willful neglect," the following is proposed: both i) increasing the current penalty; and, ii) requiring the accrual of interest on such amount during the period in which the REIT failed the relevant asset test. This penalty should be sufficient to deter inadvertent or negligent REIT test violations. Specifically, NAREIT proposes that the penalty payable by the REIT (or its successor) be increased from the greater of $50,000 or 100% of the income generated by the offending asset beginning on the date of the asset test failure multiplied by the highest corporate tax rate to the greater of $100,000 or 110% of the income generated by the offending asset beginning on the date of the asset test failure multiplied by the highest corporate tax rate, plus interest accruing on the latter amount from the original due date of the tax return for the year in which the violation first occurred until the date of payment. The penalty should be applied only once for each asset test failure (for example, if ownership of the same asset causes the REIT to fail an asset test in several quarters before the violation is discovered, the error should be viewed as a single violation).

B. Failures to Satisfy the REIT Gross Income Tests

1. *Current Law*

A REIT that fails to satisfy the 95% and 75% REIT gross income tests of sections 856(c)(2) and (c)(3) for a particular taxable year is deemed to have satisfied these provisions if, among other things, the failure was due to reasonable cause and not willful neglect. In addition, upon the REIT's identification of the failure to meet either of the gross income tests, a description of each item of the REIT's gross income must be included in a schedule for the relevant taxable year that is filed in accordance with applicable regulations.[49] The REIT must, in effect, pay a 100% tax of the amount by which the REIT failed either the 75% or 95% income test, as reduced by deductions allocable to such income.[50]

2. *Suggested Change*

Similar to the non-*de minimis* asset test violations, the present law rules would be retained for REITs whose failure to satisfy the income test or tests is due to reasonable cause and not willful neglect. For income test failures when this cannot be demonstrated, an income test failure would be remedied by increasing the current penalty payable by the REIT (or its successor) of 100% to 110% of the amount by which the REIT failed either the 75% or 95% income test, as reduced by deductions allocable to such income, plus interest from the due date of the tax until the date of payment.

[49] Section 856(c)(6)(A).
[50] Section 857(b)(5).

C. Other REIT Test Violations

1. *Current Law*

For REIT test violations other than the income or asset tests, a REIT may retain its REIT qualification so long as the violations are due to reasonable cause and not willful neglect, and the REIT pays a penalty of $50,000 for each failure.[51]

2. *Suggested Change*

a. ***Increasing Penalties***

Again, the current law rules would be retained for REITs whose "other test" failures are attributable to reasonable cause and not willful neglect.

For failures that do not meet the reasonable cause standard, in general, increasing the penalty payable by the REIT (or its successor) for "other" REIT test failures from $50,000 to $100,000 for the first such failure and to a specific level, *e.g.,* $350,000 for any subsequent failures, plus interest from the original due date of the tax return applicable to the year in which the failure occurred until the date of payment, is proposed. The maximum penalty for repeat failures is significant in that it would exceed current law's $200,000 penalty for failure to disclose a listed transaction contained in section 6707A.

Examples of REIT test failures that would fall under this rule would include: preferential dividends; failure of the requirement that REIT shares be transferable; failure of the 100 shareholder test; and failure to satisfy the "not closely held" test REIT test. Furthermore, if the maximum penalty for repeated failures was not assessed within a specific time period (such as within three years of the first identified failure), then the penalties would reset to $100,000 for the first failure after the expiration of the three year period, and the maximum penalty for subsequent failures (plus interest).

Presumably, the REIT should be required to remedy any ongoing failure within a reasonable time frame after discovery of the failure (*e.g*., if the REIT fails the closely held test, it must take steps to ensure that it is not closely held rather than just paying a penalty and remaining closely held).

REIT test failures arising from a continuing or repeated failure of the same nature or of substantially the same facts and circumstances should be considered the same failure. An example would be the failure to satisfy the "not closely held" test for more than one year due to an error in applying the attribution rules, which error is discovered after two years have passed. These successive failures would be considered one failure.

[51] Section 856(g)(5).

Again, the new relief outlined above should not be available if the REIT test violation was undertaken with a principal purpose of circumventing one or more of the REIT test requirements. It seems as though the latter requirement[52] would be the appropriate standard for an "intentional" violation that would result in de-REITing. In this rare situation, the IRS still would have the authority to enter into a closing agreement to assess an appropriate monetary penalty rather than resorting to the draconian loss of REIT status, which would negatively affect innocent shareholders.

So long as a REIT had established internal controls in compliance with the Sarbanes-Oxley Act of 2002 (relative to taxes) for a taxable year, NAREIT proposes that any "other test" failure in that year would not be deemed to be attributable to the principal purpose of circumventing the REIT rules. (The same rules would apply for REITs not subject to the Sarbanes-Oxley Act so long as they had in place the internal controls relative to taxes that would have been required if the Sarbanes-Oxley Act of 2002 applied to them.)

b. ***Procedure for IRS Notice and Review***

In response to an IRS request to have the opportunity to review self-assessed "other test" penalties, NAREIT proposes the following review process. Upon identification of an "other test" failure, the REIT would have six months to identify the failure to the IRS and attribute the failure either to: i) reasonable cause and not willful neglect, in which case, the current law penalty structure would apply; or, ii) not reasonable cause, in which case, the higher penalty structure would apply.

The IRS then would have 30 days within which to accept the REIT's attribution of the failure or to notify the REIT of its intention to review the REIT's actions to determine: i) that the failure is attributable to reasonable cause, if so claimed; or, ii) that the failure is not due to the REIT's principal purpose to circumvent the REIT rules. If the IRS declined to review the REIT's failure within the 30-day period, the REIT would self-assess the penalty as appropriate based on its notice to the IRS. In such case, the REIT's tax status could be challenged on audit with respect to the failure only to the extent the IRS could show that the failure was attributable to the REIT's principal purpose to circumvent the REIT rules.

If the IRS notified the REIT of its intention to review REIT's failure within the 30-day period, the IRS then would have 90 days within which to determine whether: i) the failure is attributable to reasonable cause, if so claimed, or, ii) the failure is not due to the REIT's principal purpose to circumvent the REIT rules. If the REIT claimed the failure is attributable to reasonable cause, and the IRS agreed, the REIT would self-assess under the current law penalty structure. The determination of "reasonable cause" could not be redetermined on audit. If the REIT claimed the failure was neither attributable to reasonable cause nor to the principal purpose to circumvent the REIT rules, and the IRS agreed, the REIT would self-assess at the proposed higher penalty structure. If the IRS determined that the failure was due to a principal purpose to circumvent the

[52] This penalty is the same as the penalty concerning the arrangements with a principal purpose of circumventing the S corporation requirement of only one class of stock. *See* Treas. Reg. § 1.1361-1(l)(2).

REIT rules, the IRS still could choose to impose a penalty in lieu of loss of REIT status, taking into account the extent to which the REIT and its shareholders benefited from the failure, and the extent to which the REIT and its shareholders would be harmed by imposition of the penalty and/or loss of REIT status. In both cases, the issue of whether the "other test" failure was due to the REIT's principal purpose to circumvent the REIT rules still could be redetermined on audit.

IV. CONCLUSION

These proposals are made under the assumption that guidance regarding "minor errors" by REITs will be issued in accordance with the current IRS Business Plan. Those changes, along with these proposals, will benefit both the government by reducing the allocation of agency resources to the determination of "reasonable cause" and the REIT industry by providing greater certainty at the cost of increased penalties.

EXHIBIT B