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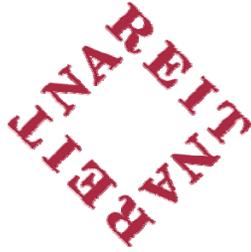
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**NATIONAL ASSOCIATION OF  
REAL ESTATE INVESTMENT TRUSTS®**

**Statement of the  
National Association of Real Estate Investment Trusts®  
to the  
Committee on Ways and Means  
Regarding the Hearing Held April 14, 2010 on  
Energy Tax Incentives Driving the Green Job Economy**

**April 22, 2010**



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The National Association of Real Estate Investment Trusts<sup>®</sup> (NAREIT) respectfully submits these comments in connection with the hearing of the Committee on Ways and Means held on April 14, 2010, regarding Energy Tax Incentives Driving the Green Job Economy. NAREIT thanks the Chairman, the Ranking Member and the Committee for the opportunity to provide these comments. NAREIT supports Congressional efforts to enact comprehensive energy incentives to grow the economy, create jobs, and reduce dependence on foreign energy. As further described below, NAREIT encourages the adoption of future incentives and clarifying language to existing incentives to ensure that real estate investment trusts (REITs) are able to fully participate in the activities contemplated by such incentives in order to further Congressional policy.

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

### **EXECUTIVE SUMMARY**

Historically, tax incentives to encourage energy efficiency and sustainability measures have been in the form of non-refundable tax credits (Tax Credits) and deductions in the Internal Revenue Code of 1986, as amended.<sup>1</sup> More recently, Congress authorized outright grants in lieu of tax credits for companies that invest in certain energy projects (Energy Grants) as part of the *American Recovery and Reinvestment Act of 2009* (ARRA). Furthermore, Congress also is considering, among other initiatives, grants to retrofit properties in order to achieve cost-effective energy efficiency savings as well as rebates to invest in energy efficient products and services related to buildings.

By way of background, REITs are widely-held companies that combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartment communities, lodging facilities, shopping centers, office buildings, health care facilities, timberlands, and warehouses, or to provide real estate financing. If REITs meet a number of requirements designed to ensure that they are focused on long-term real estate investment, and if they distribute at least 90% of their taxable income annually, they are entitled to deduct dividend distributions when determining their corporate tax bill, resulting in one level of taxation to the shareholder. As of December 31, 2008, REITs owned an estimated 6 billion square feet of real estate.

Buildings account for 40% of all energy use and almost 70% of all electrical energy use in the United States. As the 111th Congress continues to consider energy tax incentives designed to grow the U.S. economy, create new jobs, reduce the reliance on foreign energy, and enhance the use of renewable energy in the U.S., NAREIT recommends that existing energy incentives be modified, and future energy tax incentives be designed, to ensure that REITs, as significant owners of U.S. real estate, are able to utilize such incentives consistent with, and in a manner that furthers, national policy.

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<sup>1</sup> Unless otherwise provided, the Code, and any reference herein to a "Section," shall be to a section of the Code.



Our members have a strong commitment to investing and operating in an energy efficient manner and are eager to invest in more energy efficiency measures, thereby both creating jobs and minimizing negative environmental impact. Unfortunately, existing energy tax incentives do not work for REITs. First, existing Tax Credits cannot be used by REITs on a practical basis because they have little to no federal income tax liability at the entity level. Neither may these tax credits be passed through to REIT shareholders, who are ultimately subject to tax on a REIT's income. Further, even to the extent a REIT may have creditable tax liability, the Tax Credits are reduced based on the amount of income not retained by the REIT. Similarly, even the recently enacted Energy Grants apparently are only available to REITs to the extent they retain taxable income. Third, existing deductions attributable to expenses for certain energy efficiency projects are either too difficult to certify or are structured so that REIT shareholders cannot appropriately benefit from the REIT's reduced taxable income. As a result, the congressional incentives to stimulate the economy in a sustainable manner are not available to a significant segment of the commercial real estate industry well suited to deploy these new technologies.

Specifically, and as further described below, NAREIT recommends that Congress:

1. In connection with investments in "specified energy property" as defined in Section 1603(d) of ARRA and "energy property" as defined in Section 48,
  - a) modify Section 1603 of ARRA so that REITs may benefit fully from Energy Grants without limitation based on their statutorily mandated distribution obligation, as reflected in H.R. 4256;
  - b) enact a refundable energy tax credit also available to REITs without limitation based on their statutorily mandated distribution obligation, as reflected in H.R. 4599; and,
  - c) in both cases, clarify that the right to receive the Energy Grants or Tax Credits is a "real estate asset" under the REIT asset tests and conform the recovery periods for taxable income and "earnings and profits" purposes to prevent over taxation and/or double taxation of REIT shareholders;
2. Increase the Section 179D deduction for energy efficient commercial building expenses and streamline the certification procedure as reflected in H.R. 4226 and S. 1637, and enact modifications to the earnings and profits calculation under Section 179D so that the benefit of the incentives would be reflected in the distributions received by REIT shareholders;
3. Extend and modify the Section 45L new energy efficient home credit to make this tax credit available to all owners of multifamily properties, as reflected in H.R. 4226 and S.1637, and allow REITs to claim this credit as an economically equivalent deduction;
4. If legislation is passed that requires buildings to meet higher energy efficiency standards, then enact programs that provide for retrofitting grants to retrofit existing buildings for energy efficiency, as well as clarify that the right to receive such grants is a qualifying "real estate asset" that generates qualifying gross income for REITs; and,



5. Enact S. 3079, which would authorize a program entitled “Building STAR” to encourage retrofitting of commercial and multi-family buildings through a program of improvements to existing, and, in some cases, proposed, tax incentives and rebates.

## **DISCUSSION**

### **I. REITs**

#### **A. Background**

Congress created REITs in 1960 to make investments in large-scale, significant income-producing real estate accessible to small as well as large investors from all walks of life. In much the same ways as shareholders benefit by owning a portfolio of securities in a mutual fund, the shareholders of REITs can unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors: greater diversification through investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals. As of March 2010, there were approximately 140 publicly traded REITs with an equity market capitalization of approximately \$300 billion. Further, IRS tax return data indicates that in 2006 about 1,400 companies filed REIT tax returns.

#### **B. REIT Distribution and Income and Asset Test Requirements**

In exchange for distributing at least 90% of their annual taxable income to shareholders, and for satisfying a number of other requirements, federal law grants REITs a dividends paid deduction (DPD) so that a REIT’s income is taxed only once, at the shareholder level.<sup>2</sup> As a result, in 2008 listed REITs distributed over \$17 billion to shareholders.

At least 75% of the value of a REIT’s assets quarterly must consist of specifically delineated “real estate assets” such as interests in real property and mortgages secured by real property (the Asset Test). Furthermore, at least 75% of a REIT’s annual gross income must be from specifically delineated income sources such as “rents from real property” (as such term has been defined) and interest on mortgages secured by real property (75% Income Test). At least 95% of a REIT’s annual gross income must be from items that qualify for the 75% Income Test, as well as from passive types of income like non-real estate interest and dividends (the 95% Income Test, and together with the 75% Income Test, the Income Tests). Failure to satisfy these (and other) requirements can result in the draconian penalty of loss of REIT status.

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

Since the authorization of REITs in 1960, Congress and the IRS have refined the definitions of qualifying “real estate assets” under the Asset Test and real estate-related income under the Income Test in order to conform to changes in the real estate marketplace. For example, in the

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<sup>2</sup> A REIT is subject to a corporate level tax to the extent that it distributes less than 100% of its taxable income and under certain other circumstances.



*Housing and Economic Recovery Act of 2008* (Pub. L. 110-289) (the 2008 Act), Congress amended the Income Tests so that foreign currency gains incurred as part of a REIT's real estate business overseas would not be taken into account under the Income Tests. Similarly, the 2008 Act treats a REIT's foreign currency owned in connection with its real estate business specifically as a good real estate asset.

Additionally, Congress provided the IRS with authority in the 2008 Act to determine whether specific types of income not specifically listed as qualifying REIT income in fact are qualifying types of income for the Income Tests. This legislation clarifies that a REIT may earn certain income and hold assets consistent with its core mission as a REIT without having such income and/or assets negatively affect its tax status as a REIT. Finally, while not REIT-specific, Congress provided that the Energy Grants specifically are excluded from the gross income of the recipients of such grants.

D. Taxation of REIT Shareholders: Calculation of Earnings and Profits (E&P)

As noted above, REITs are required to distribute at least 90% of their taxable income as a dividend. To do so, the REIT must make two sets of calculations: one for taxable income purposes, and one for "dividends paid." A REIT calculates how much dividends it has paid based on what is termed "earnings and profits" or "E&P." Because E&P is meant to represent the economic position of the distributing corporation, shareholders are taxed on distributions, first, to the extent of current and accumulated E&P, then as a return of capital (which reduces the shareholder's tax basis in his or her stock shares), and, thereafter (typically) as an amount realized from the sale or exchange of a capital asset.

Thus, a REIT must calculate both its taxable income and its E&P. In simple cases, these two items may be the same. For example, if a REIT earns mortgage interest of \$100 and has interest expense of \$40, the REIT has taxable income of \$60 (\$100-\$40), and E&P of \$60 as well. If the REIT distributes \$80, under this example, \$60 would be considered ordinary dividends and \$20 would be considered a return of capital that reduces a shareholder's tax basis in his or her shares in the REIT.

The potential for over-taxation or double taxation of shareholders arises when the calculations for taxable income and earnings and profits diverge. Because REITs often distribute in excess of 100% of taxable income, if E&P is not reduced at the same time a deduction is claimed for taxable income purposes, shareholders will be overtaxed. Depreciation used to calculate E&P often differs, sometimes materially, from the depreciation used to determine taxable income.<sup>3</sup> Assume a REIT has rent of \$100 and depreciation of expense of \$40. If only \$30 in depreciation were used to calculate E&P, and the REIT distributed \$80, then \$70 (\$100-\$30) of the \$80 would be considered ordinary dividends (even though there would be \$60 for taxable income purposes), and therefore the shareholders would be artificially overtaxed by \$10. Thus, the shareholders would not realize the full benefit of the \$40 depreciation deduction.

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<sup>3</sup> For example, apartments are depreciated over 27.5 years for taxable income purposes but over 40 years for E&P purposes.



## II. RECOMMENDATIONS

### A. Amend Energy Grants Provision and/or Enact Refundable Tax Credits to Encourage REIT Investment in Renewable Energy Measures without Limitation Based on Retained Income

#### 1. *Amend the ARRA to Allow REITs to Participate Fully without Income Limitation in the Energy Grants Program*

Recognizing the need to encourage qualifying investments by taxpayers whose tax liability may not be sufficient to benefit from Tax Credits, Congress authorized the Energy Grants program last year. Under ARRA, a taxpayer can receive a cash grant from the Treasury Department equal to 30% of its investment in certain renewal energy property. The Energy Grants provisions have been interpreted to benefit a REIT only to the extent it retains taxable income.

As Congress considers energy tax incentives legislation, it should amend Section 1603 of ARRA to allow REITs to participate fully in the energy grants in lieu of tax credits program without a limitation based on their statutorily mandated payment of taxable income as dividends to shareholders. NAREIT fully endorses H.R. 4256, the *Sustainable Property Grants Act of 2009*, which would accomplish this goal.<sup>4</sup> NAREIT thanks Representative Linda Sánchez and the other co-sponsors of this legislation for their leadership in connection with this important provision.

#### 2. *Refundable Tax Credits*

An alternative approach to the Energy Grant in Lieu of Tax Credit provision would be the authorization of a refundable energy tax credit, fully administered by the IRS, as reflected in H.R. 4599, the *Renewable Energy Expansion Act of 2010*. NAREIT strongly urges enactment of the provisions in this bill and thanks Representative Earl Blumenauer and the other bill co-sponsors for promoting this legislation. As with H.R. 4256, REITs would be entitled to claim refundable tax credits regardless of their distribution of taxable income.

#### 3. *Clarify E&P Calculation to Prevent Over-Taxation and Double Taxation of REIT Shareholders*

As a general matter, with respect to REITs, we recommend that any deductions in the Code, including those for depreciation with respect to energy property that qualifies for Energy Grants (or Refundable Tax Credits) be the same for taxable income as for E&P purposes. For example, our understanding is that the recovery period for depreciation deductions with respect to taxable income for Energy Grant property such as solar roof panels is five years, while the recovery period for E&P is twelve years. This mismatch can result in a number of adverse consequences for REITs and their shareholders. First, because REITs often distribute in excess of 100% of their taxable income annually, their shareholders are likely to be overtaxed in the first five years

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<sup>4</sup> Congress also may wish to consider a modification to the existing Tax Credit regime to allow REITs to treat their lessees as purchasers of qualified energy property, thereby allowing the lessees to claim the Tax Credit for the REIT's investment in such property. The result of such a structure also would be increased qualifying rent to the REIT, decreased energy costs for the lessee, and overall benefit to the environment through reduced energy usage.



of the Energy Grant property's life because E&P will be overstated (due to slower depreciation).<sup>5</sup> Second, once the Energy Grant property is fully depreciated for taxable income purposes, and depending on the extent of the mismatch between taxable income and E&P in this and other contexts, the REIT may have difficulty satisfying its requirement to distribute at least 90% of its taxable income as a dividend (that is, supported by E&P) because its E&P will continue to decline from depreciation deductions while its taxable income will not.<sup>6</sup>

Furthermore, the effect on REIT shareholders noted above could continue: REIT E&P could be "artificially" high, thereby resulting in the treatment of an "artificially" greater portion of shareholders' distributions as taxable dividends.<sup>7</sup> Thus, in a worst case scenario, the difference in recovery periods may cause a REIT to lose its REIT status and be subjected to tax at both the entity and shareholder levels.

Accordingly, NAREIT recommends that the recovery period for Energy Grant property for E&P be conformed to that for taxable income purposes.<sup>8</sup>

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<sup>5</sup> Because of the extent of the mismatch, this result is the case even though Section 312(k)(5) (basis for calculating depreciation is tax basis without reduction by 50% of the amount of the Energy Tax Credits and presumably Energy Grants as well) may apply.

<sup>6</sup> Section 857(d)(2) provides that a REIT will always be treated as having adequate earnings and profits to make distributions as dividends sufficient to avoid the excise tax under Section 4981. The rules for determining the "required distribution" for purposes of avoiding the excise tax under Section 4981 are complicated, but they basically require a distribution as a dividend of 85% of the REIT's ordinary income and 95% of the REIT's capital gain net income. Because Section 857(d)(2) only ensures sufficient earnings and profits to avoid the excise tax and does not provide sufficient earnings and profits to meet the 90% distribution test under Section 857(a)(1), it is possible that the REIT could fail the distribution test due to the mismatch here and in other contexts.

<sup>7</sup> If the increased depreciation of Energy Grant property for earnings and profits purposes in years 6-12 (and in other contexts) require a REIT to invoke Section 857(d)(2) so that it would have enough earnings and profits to avoid the excise tax under Section 4981, this effective disallowance of depreciation for E&P purposes would cause the REIT shareholders to report artificially high dividend income in those years. In addition, there is an alternate view that no deductions for depreciation are permissible against E&P in years 6-12 due to the application of § 857(d)(1) (which prohibits reducing E&P for any taxable year by an "amount" not "allowable" in computing taxable income for such year). If this view were correct, the REIT should not fail to meet its 90% distribution requirement. On the other hand, a REIT shareholder would be placed in an even worse position with the 5-year depreciation period than it is in with a 12-year depreciation period. Under this view, E&P would be reduced in years 1-6 based on a 12-year depreciation recovery period, but E&P would not be reduced at all in years 6-12, thereby greatly increasing the taxable portion of the REIT's distribution in the latter years. Thus, the shareholder could end up paying tax on income that greatly exceeds the income that is earned by the REIT.

<sup>8</sup> The current mismatch in this context also creates the potential for double taxation of REIT shareholders. Specifically, it appears that E&P increases by the full amount of the Energy Grant in the year of receipt although it reduces tax basis by 50% of the amount of the Energy Grant. When the Energy Grant property is sold, part of that reduction in tax basis will be included in the tax gain and possibly the E&P once again, arguably resulting in double taxation of REIT shareholders on 50% of the Energy Grant amount. Section 562(e) properly includes such gain for purposes of the DPD. Section 857(d)(1) is unclear as to whether it mirrors this E&P result for shareholders. Although it also appears that Section 312(k)(5) might eliminate this problem over the life of the relevant property by increasing E&P basis and therefore allowing for greater depreciation deductions for E&P purposes, its effect is possibly limited by Section 857(d)(1), as described above. Conforming the recovery periods for taxable income and E&P purposes should minimize the extent of this potential double taxation. Further, the shorter taxable income recovery period should be the recovery period chosen to provide the greatest incentive for REITs to undertake these kinds of valuable projects.



4. *Clarify that the Right to Receive Energy Grants and Refundable Tax Credits is a “Real Estate Asset” Under the REIT Asset Tests*

As noted above, REITs must satisfy the Asset and Income Tests in order to maintain their qualification as REITs. To prevent Energy Grants and/or Refundable Tax Credits from jeopardizing a REIT’s tax status, NAREIT recommends that Congress clarify that the right to receive both items would be considered a “real estate asset” for purposes of the REIT Asset Tests.

B. Enact S. 1637/H.R. 4226 with REIT-Related Modifications to Enhance the Deduction for Energy Efficient Commercial Buildings and Extend Energy Efficient Home Tax Credits to All Multifamily Residences

1. *S. 1637/H.R. 4226*

As part of energy legislation adopted in 2005, Congress created Code Section 179D, which allows a commercial building owner to receive a deduction equal to \$1.80 times the square footage of a building for property installed to meet very strict energy efficiency standards. The legislation also created a tax credit under Section 45L for home residence energy investments, which were later extended by regulation to owners of multi-family residences (including apartments and senior living communities) so long as they were three stories or less. Unfortunately, these deductions and credits have not been used very much because they are not sufficiently robust to make the targeted investments economically viable. S. 1637, the *Expanding Building Efficiency Incentives Act of 2009*, and its companion bill, H.R. 4226, would enhance the deduction for energy efficient commercial buildings in Section 179D and would extend energy efficient home credits. NAREIT supports the enactment of the provisions in these bills, with the modifications discussed below.

2. *Conform E&P to Taxable Income from Section 179D Deductions*

As noted above in the Energy Grant section, we recommend that the deductions in the Code, including those authorized under Section 179D, be coupled with a corresponding deduction for E&P purposes. Under current law, although Section 179D authorizes certain deductions from taxable income, these deductions do not immediately reduce E&P, but instead reduce it pro rata over a five-year period.

Unless the Section 179D deduction also reduces REIT E&P by a corresponding amount, a REIT’s shareholders will not get the benefit of the increased deduction because their taxable dividends are keyed off E&P, not the REIT’s taxable income. Under current law, REIT shareholders would receive only one-fifth of the benefit of the Section 179D deduction per year. Depending on the extent of this and other disparities between taxable income and E&P, this mismatch also could leave a REIT without sufficient E&P in later years to meet its distribution requirement (or, as described in the section on Energy Grants, could overtax REIT shareholders). As a result, deductions like those in Section 179D currently provide limited incentive to REITs.



Accordingly, NAREIT recommends that if S. 1637/H.R. 4226 are enacted, Congress also provide that the Section 179D deduction for E&P purposes be conformed to that for taxable income purposes, and, thus, be allowed to reduce E&P immediately instead of over five years.

3. *New Energy Efficient Home Credit: Section 45L/Allow for Equivalent Deduction*

As noted above, Section 45L provides a tax credit for investment in energy efficient homes. We understand that listed REITs own approximately 7% of commercial grade apartment stock, yet this portion of the multifamily market cannot benefit from energy tax credits. Again, because REITs are required to distribute at least 90% of their taxable income (and most distribute 100% or more), REITs generally do not have any federal income tax liability at the entity level that could be offset by tax credits. To create any incentive for REITs to invest in energy reduction projects, we believe that REITs should be afforded the flexibility of claiming the incentive as a tax deduction, rather than a tax credit.

Furthermore, because a tax credit affords a dollar-for-dollar reduction in tax liability, while a tax deduction only reduces tax liability by the amount of the deduction multiplied by the tax rate applicable to the income, we recommend “grossing up” any deduction to achieve the same economic result as a tax credit.

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

$$\text{Credit} = [\text{“Grossed up” Deduction}] * [\text{tax rate}]$$

$$\text{Thus, “Grossed up” Deduction} = [\text{Credit}] / [\text{tax rate}]$$

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

Because a REIT would be subject to the highest marginal rate of 35% to the extent that it retained any taxable income, and, accordingly, had a federal income tax liability, we suggest using a 35% tax rate. As an illustration, a tax credit of \$100 could save a non-REIT taxpayer \$100 in federal income tax liability. Assuming a 35% tax rate, in order for that credit to provide the REIT with the same economic benefit as a deduction, it would need to be converted into a deduction of \$285 ( $\$100/.35=\$284.9$ ).

C. Enact Retrofitting Grants Programs/Clarify that the Right to Receive Such Grants is a Qualifying REIT Asset that Generates Qualifying REIT Income

As part of the comprehensive climate change legislation adopted by the House of Representatives in June 2009, a “National Energy Efficiency Building Code” would effectively create a minimum standard for local building codes. Under this proposal, buildings would be required to improve energy efficiency by 30% by 2010, and by 50% by 2016.



In addition, the bill would provide federal grants over a four-year period for state and local agencies to distribute for retrofitting projects to achieve the ambitious energy efficiency standards in existing buildings that would be established by the bill. This provision, authored by Representative Peter Welch, would give building owners direct cash incentives for up to half of the total retrofit cost based on their efficiency improvements. Specifically, it would provide \$0.15 per square foot for energy reductions of 20-30%, \$0.75 per square foot for reductions of 30-40%, \$1.60 for reductions of 40-50%, and \$2.50 for reductions over 50%.

Without clarification that these grants should be considered qualifying REIT assets that generate qualifying REIT income, it is quite possible that REITs would not participate in the program out of fear of jeopardizing a REIT's tax status. Consequently, NAREIT pursued clarifying language during floor debate of the House Bill; unfortunately tax-related provisions were not considered prior to House passage. However, during debate of the bill, Representative Welch stated his support for providing the necessary clarification language once the bill moves further through the legislative process.<sup>9</sup> NAREIT recommends that if Congress enacts legislation authorizing these retrofitting grants, it should clarify that such grants are qualifying real estate assets that generate qualifying real estate income under the REIT tax rules.

D. Enact S. 3079, Authorizing the Building STAR Program to Provide Rebates for Energy Efficient Equipment, Materials and Services

The product of a wide consultation among members of *Rebuilding America*, a coalition of more than 80 business, real estate, financial, labor, consumer, environmental, and advocacy organizations, S. 3079 would authorize the Building STAR program, a rebate program for building owners and managers who install or implement nearly 20 different types of energy efficient equipment, materials, and services during 2010 and 2011. The Building STAR rebates would cover approximately 20-30% of the cost of installing energy efficient products and/or services (such as building performance audits) during 2010 and 2011. Rebates are capped at 50% of the total cost of the product or service for a given building. Moreover, they are largely based on proven, existing rebate programs offered by some states and utilities.

The Building STAR program would provide significant incentives to modernize extensive commercial real estate stock in the United States, with high efficiency equipment, materials, and services. Building STAR would stimulate the economy, create jobs, save energy and money, and reduce greenhouse gas emissions. NAREIT recommends that Congress adopt this program to encourage the creation of jobs in a sustainable economy.

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

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<sup>9</sup> 155 Cong. Rec. H7634 (June 26, 2009).

