

Energy and Environmental Retrofitting of Commercial Real Estate
Grants Should be Qualifying REIT Assets that Generate Qualifying REIT Income

Background

NAREIT supports grant programs that provide direct incentives for efficiency improvements in residential and commercial buildings. Buildings account for 40% of total energy use and almost 70% of electrical energy uses in the United States. SEC registered REITs own and manage approximately 6 billion square feet of commercial real estate which, if retrofitted, could yield significant energy savings. Programs like the Retrofit for Energy and Environmental Performance (REEP) Program, which was included as section 202 in H.R. 2454, the *American Clean Energy and Security Act of 2009*, or the State Energy Retrofit Grants Program, which was included as section 262 in the Senate Energy Committee's mark of S. 1462, the *American Clean Energy Leadership Act*, will encourage energy efficiency and environmentally responsible retrofitting and development practices.

Issue: Without Clarification, REITs May Not Participate in Grant Programs

Without clarification from Congress these grants will be considered qualifying REIT assets that generate qualifying REIT income, REITs may be concerned that they will lose their tax status if they participate in this program. In order for a company to qualify as a REIT, it must comply with certain tax rules designed to ensure that it is real estate-focused. Among other things, the company must satisfy asset and income tests. Specifically, at least 75% of a REIT's annual gross income must be from those sources and other passive sources like dividends and non-real estate interest (Income Tests). Similarly, at least 75% of a REIT's assets on a quarterly basis must consist of specified real estate sources (Asset Test). Failure to satisfy these tests and other REIT rules can jeopardize a REIT's tax status.

NAREIT pursued clarifying language in H.R. 2454, but Ways and Means did not act on tax provisions as part of this bill. Nevertheless, during floor debate on the measure, Representative Peter Welch (D-VT), the champion of the REEP Program in the House, stated his intention to ensure participation by REITs in the program by including the necessary clarifications as the bill moves through the legislative process. In the Senate, NAREIT submitted testimony to the Finance Committee for its hearing on June 16, 2009, "Climate Change Legislation: Tax Considerations."

Action Requested

As the Senate continues to draft energy and climate change legislation, NAREIT supports the creation of grant programs for retrofitting and requests that the appropriate clarifications be included to allow REITs to participate fully. Over the years, Congress and the IRS have refined the definition of qualifying REIT income and assets to conform to changes in the real estate industry. For example, in last year's *Housing and Economic Recovery Act of 2008* (Pub. L. 110-289), Congress amended the Income tests so that foreign currency gains incurred as part of a REIT's real estate business would not be taken into account for purposes of the Income Tests. The IRS also has ruled privately numerous times that real estate related assets and income not specifically listed in the Tax Code as qualifying REIT gross income or assets nevertheless are considered qualifying income or assets or not taken into account in analyzing those rules.



Proposed Language

The draft language included below is one way to provide the necessary clarification for section 202 of H.R. 2454, the *American Clean Energy and Security Act of 2009*. The first two sections add a category to the 75% and 95% REIT gross income tests, respectively, so that REEP and similar grants are qualifying gross income for REITs. The last section treats REEP and similar grants as a "real estate asset" for purposes of the rule that 75% of a REIT's assets quarterly be in "real estate assets, cash and cash items."

SEC. __. REVISIONS TO REIT INCOME TESTS.

(a) ADDITION OF PERMISSIBLE INCOME CATEGORIES. — Section 856(c) (relating to limitations) of the Internal Revenue Code of 1986 (26 U.S.C. 856(c)) is amended

—
(1) by striking “and” at the end of paragraph (2)(H), and inserting the following after paragraph (2)(I):

and (J) any direct or indirect expenditure, grant, award or other assistance received pursuant to section 202 of the American Clean Energy and Security Act of 2009 or any similar direct or indirect expenditure, grant, award or other assistance under federal, state, or local law in connection with energy efficiency improvements, significant improvements in water use and other environmental attributes, or climate change;

and

(2) by striking “and” at the end of paragraph (3)(H), and inserting the following before the “and” after paragraph (3)(I):

“(J) any direct or indirect expenditure, grant, award or other assistance received pursuant to section 202 of the American Clean Energy and Security Act of 2009 or similar direct or indirect expenditure, grant, award or other assistance under federal, state, or local law in connection with energy efficiency improvements, significant improvements in water use and other environmental attributes, or climate change; and.”

SEC. __. REVISIONS TO REIT ASSET TESTS

(a) CLARIFICATION OF PERMISSIBLE ASSET CATEGORY. —Subparagraph (B) of Section 856(c)(5) of the Internal Revenue Code of 1986 (26. U.S.C. 856(c)(5)) is amended by adding the following new sentence:

(b) “Such term also includes any direct or indirect expenditure, grant, award or other assistance received pursuant to section 202 of the American Clean Energy and Security Act of 2009 or similar direct or indirect expenditure, grant, award or other assistance under federal, state, or local law in connection with real property energy efficiency improvements, significant improvements in water use and other environmental attributes, or climate change related to real property.”

