May 13, 2009

VIA HAND DELIVERY AND U.S. MAIL

The Honorable Michael Mundaca
Deputy Assistant Secretary (International Tax Affairs)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 3045
Washington, DC 20220

The Honorable Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Room 3000
Washington, DC 20224

Re: Guidance Request With Respect to Energy Grants in Lieu of Credits

Gentlemen:

The undersigned organizations, the American Hotel & Lodging Association (AH&LA), the Building Owners and Managers Association (BOMA) International, the International Council of Shopping Centers (ICSC), NAIOP, the Commercial Real Estate Development Association (NAIOP), the National Apartment Association (NAA), the National Association of Real Estate Investment Trusts® (NAREIT), the National Multi Housing Council (NMHC), and The Real Estate Roundtable (Roundtable) appreciate the opportunity to request regulatory guidance under Section 1603[1] of the American Recovery and Reinvestment Act (the Act), which provides for a grant for a portion of the expense of placing in service "specified energy property" (Energy Grants) in lieu of a tax credit for such property.

Specifically, we request that, because Energy Grants are available without regard to tax liability, the Treasury Department and IRS should clarify that Section 1603 of the Act applies to real estate investment trusts (REITs) without a limitation based on the amount of taxable income retained by the REIT. Descriptions of the undersigned organizations are included in the Appendix to this submission.

EXECUTIVE SUMMARY

On February 17, 2009, President Obama signed the Act, which includes a provision that provides an outright grant for companies that invest in certain energy projects (Energy Grants). Although the tax law already includes energy tax incentives in the form of credits, these Energy Grants

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

encourage taxpayers whose tax liability may not be sufficient to undertake projects that generate energy tax credits to undertake investment in renewable energy projects. In general, the Energy Grants are available in 2009 and 2010. "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 that the Treasury Department and IRS issue guidance that interprets this legislation in the manner most likely to encourage REITs and other taxpayers to invest in renewable energy projects—without limitation based on their ultimate tax liability. 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.

DISCUSSION

To Remain Consistent with the Congressional Policy of Encouraging Investment in Renewable Energy Projects, Guidance Should Clarify That Energy Grants Are Available to REITs Regardless of Taxable Income

A. Background

1. REITs

a. Only One Level of Taxation for Distributed Earnings of Qualified REITs

Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through companies modeled after mutual funds. Just as mutual funds allowed investors to pool their resources to acquire a diversified portfolio of stocks and securities, REITs similarly combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, hotels, shopping centers, offices, timberlands, and warehouses. Just as distributed earnings of mutual funds were subject to a single level of taxation at the shareholder-level, so too would distributed earnings of REITs similarly be subject to shareholder-level only taxation. The House Ways and Means Committee described its reasons for the creation of the REIT provisions as follows:

> The omission of the corporate income tax in the case of distributed earnings, which present law provides for [mutual funds] secures [for mutual fund investors] essentially the same tax treatment as they would have received if they had invested directly in the [stocks and securities owned by the mutual funds]. H.R. 12559 extends this same type of tax treatment to [REITs]. . . . [T]he equality of tax treatment between the beneficiaries of [REIT] and the shareholders of [mutual funds] is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to

> secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.

H.R. Rep. No. 2020, 86th Cong., 2d Sess. at 820, 821 (1960).

Just like mutual funds, REITs are required to distribute at least 90% of their taxable income to their shareholders. In exchange for doing so (and for satisfying a number of other requirements to ensure that they are real estate focused), federal law grants REITs a dividends paid deduction (DPD). For example, REITs must satisfy quarterly asset tests and annual income tests demonstrating significant real estate assets and income from such assets. Specifically, under section 857(a), in order to maintain REIT status, a REIT's DPD generally must equal or exceed 90% of a REIT's "REIT taxable income" (REITTI) for the year.

Typically, most Securities and Exchange Commission (SEC) registered REITs distribute 100% of their taxable income as a dividend annually. As a result, the income and gain of these REITs are generally taxed solely at the shareholder level. As a result of the recent economic crisis, some REITs have attempted to reduce their distributions to equal 90% of their REIT taxable income in an effort to conserve capital. To the extent that REITs retain up to 10% of their taxable income, they pay tax at the corporate level on this amount.

SEC-registered REITs own an estimated 6 billion square feet of commercial space (as of December 31, 2008). In addition to the 200 or so SEC-registered REITs, IRS data shows that another 1,200 or so entities file Forms 1120-REIT. Thus, REITs own and control a significant amount of commercial real estate assets in the United States that could be used for the sustainable energy property contemplated by the Act, especially solar power equipment.

b. Umbrella Partnership REITs and Pass-Through Entity Structures: Prevalent Method for U.S. Real Estate Ownership

The majority of listed REITs operate through the umbrella partnership (UPREIT) format in which the publicly traded REIT owns substantially all of its assets and conducts substantially all of its operations through an operating partnership (OP). As a general rule, the REIT will own a number of "common units" in the OP equal to the number of shares of common stock that the REIT has outstanding. In addition, if the REIT has preferred stock outstanding, the REIT will own "preferred units" in the OP that correspond to the shares of preferred stock that the REIT has outstanding.

Typically, the REIT acquires its interest in the OP in one of two ways, both evidencing a substantial equity investment in the OP. First, the REIT may sell its shares in an initial public offering and contribute the cash proceeds to the OP. Alternatively, the REIT may contribute real property or partnership interests in partnerships that own real property to the OP. Then, the REIT (or a subsidiary) typically acts as the sole general partner of the OP, and has the exclusive right to manage the affairs of the OP, subject to limitations intended primarily: 1) to preserve the effective economic identity of interest that exists between the units and the REIT shares; and, 2) to avoid the REIT or OP taking actions that would eliminate or adversely affect the

redemption/exchange right for unitholders. Since all employees of the real estate business are typically at the OP level (and below), and because the OP must generate qualifying REIT income and hold qualifying real estate assets, in order for the REIT to preserve its tax status, the OP essentially conducts the business of the REIT as if it were a REIT.

Furthermore, just like other real estate owners, REITs and their OPs also invest in real estate through joint venture limited partnerships or limited liability companies (LLCs) with third parties. The limited partnership (and now the LLC) is and has been for decades the prevalent method for owning real estate in the U.S.

2. Energy Tax Credits: Sections 48 and 50

a. Generally

Section 48 provides for an energy tax credit based on a percentage of the basis of qualified energy property placed in service during a taxable year. Qualified energy property includes property such as solar property, fuel cell property, small wind property, combined heat and power system property or geothermal property. The percentage at which the energy credit is calculated depends on the type of property (e.g. 10% for combined heat and power property).

The energy credit under section 48 is included as an investment credit for purposes of Subpart E of the Code, *Rules for Computing Investment Credit*, which includes sections 46 through 50. The investment credits of Subpart E are general business credits for purposes of Subpart D, under section 38. The energy credit is allowed as a credit against tax, limited under section 38(c)(4)(B)(vi) to income tax liability including any tentative minimum tax.

b. Special Rules

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

In effect, this limitation reduces the energy credit under section 48 for a REIT based on the proportion of net income that is not paid out in dividends. As the amount of the credit is reduced, the corresponding amount of basis reduction required under section 50 is reduced as well, mitigating the differential that would otherwise exist between the amount of credit allowed against tax (generally zero in the case of REITs) and the amount of basis reduction. This

limitation is therefore helpful to REITs. Absent this provision, REITs otherwise could be required to reduce basis by the entire amount of the credit even though the REIT obtained zero benefit from the credit as a result of having distributed 100% of taxable income (and therefore having no tax liability against which to use the tax credit). The limitation operates by limiting the amount of basis reduction based on the amount of taxable income retained by the REIT. The practical effect of this limitation, and the fact that current law does not permit a REIT to pass through these tax credits to shareholders, is that REITs have not focused extensively on undertaking the types of projects that generate these credits.

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

3. American Recovery and Reinvestment Act of 2009 (the Act): Section 1603

a. Purposes of Act

Section 3 of the Act states its purposes:

> (a) Statement of Purposes- The purposes of this Act include the following:
>
> (1) To preserve and create jobs and promote economic recovery.
> (2) To assist those most impacted by the recession.
> (3) To provide investments needed to increase economic efficiency by spurring technological advances in science and health.
> (4) To invest in transportation, environmental protection, and other infrastructure that will provide long-term economic benefits.
> (5) To stabilize State and local government budgets, in order to minimize and avoid reductions in essential services and counterproductive state and local tax increases.

The Senate Committee on Appropriations submitted a report for a bill, some of whose provisions were folded into the Act, and noted that:

> All economists agree that the Nation is facing one of the most dire economic crises in our history. Over the past 2 months more than 1 million jobs have been lost. Nothing indicates that similar job losses won't continue unless the Federal Government acts. . . . The country is enmeshed in a grave crisis. It is imperative that the Federal Government use all means at its disposal to address the problems. . . . With each passing week that the Congress fails to address our economic problems, additional thousands will continue to join the ranks of the unemployed. Inaction will only add to our challenges. This measure is only one step but it is a very important step in addressing this problem.

S. Rep. No. 3, 111th Cong., 1st Sess. at 3-4 (2009).

b. Energy Grants in Lieu of Tax Credits

i. Generally

The Act contains a number of energy-related provisions designed to "create more than 500,000 jobs, and accelerate deployment of smart grid technology, provide energy efficiency funds for the nation's schools, offer support for the nation's governors and mayors to tackle their energy challenges, and establish a new loan guarantee program to keep our transition to renewable energy on track during the economic crisis."[2]

This letter focuses on the grant provisions under Section 1603 of the Act. Specifically, Section 1603 of the Act provides that Energy Grants are made available in lieu of credits for specified property placed in service in 2009 or 2010 (or placed in service after 2010 and before the credit would otherwise terminate, if construction began in 2009 or 2010) that is otherwise eligible for the energy credit under section 48.

Section 1603(f) of the Act provides for the application of "rules similar to the rules of section 50 of the Internal Revenue Code of 1986" to the grants. In addition, Section 1603(f) of the Act specifically addresses recapture rules also addressed in section 50(a). Furthermore, the basis of the eligible property is reduced by 50% of the amount of the grant. Finally, the grant is not available to the following entities: 1) any Federal, State, or local government (or any political subdivision, agency, or instrumentality thereof); 2) any organization described in section 501(c) and exempt from tax under section 501(a); 3) any entity referred to in section 54(j)(4) [a clean renewable bond lender, cooperative electric company, or governmental body]; or, 4) any partnership or other pass-thru entity any partner (or other holder of an equity or profits interest) of which is described in paragraph 1), 2) or 3).

Importantly, REITs are not included in this list of excluded entities. Thus, REITs clearly are permitted to obtain Energy Grants.

The Act also amended section 48 in a number of ways. As relevant to the Energy Grants, the Act added section 48(d) which provides:

> ''(d) COORDINATION WITH DEPARTMENT OF TREASURY GRANTS.—
> In the case of any property with respect to which the Secretary
> makes a grant under section 1603 of the American Recovery and
> Reinvestment Tax Act of 2009—
> ''(1) DENIAL OF PRODUCTION AND INVESTMENT CREDITS.—
> No credit shall be determined under this section or section

[2] Speaker of the House Nancy Pelosi (D-CA), quoted in http://www.speaker.gov/newsroom/legislation?id=0273. Speaker Pelosi also quotes the National Resources Defense Council's Feb. 13, 2009 statement on the Act that "[r]enewable energy grants will help struggling businesses cope with the economic climate and advance technology that harnesses the power of the wind and sun…The economic recovery package reflects the commitment by Congress to fulfill President Obama's vision for a clean energy future."

> 45 with respect to such property for the taxable year in which
> such grant is made or any subsequent taxable year.
> ‘‘(2) RECAPTURE OF CREDITS FOR PROGRESS EXPENDITURES
> MADE BEFORE GRANT.—If a credit was determined under this
> section with respect to such property for any taxable year
> ending before such grant is made—
> ‘‘(A) the tax imposed under subtitle A on the taxpayer
> for the taxable year in which such grant is made shall
> be increased by so much of such credit as was allowed
> under section 38,
> ‘‘(B) the general business carryforwards under section
> 39 shall be adjusted so as to recapture the portion of
> such credit which was not so allowed, and
> ‘‘(C) the amount of such grant shall be determined
> without regard to any reduction in the basis of such property
> by reason of such credit.
> ‘‘(3) TREATMENT OF GRANTS.—Any such grant shall—
> ‘‘(A) not be includible in the gross income of the taxpayer,
> but
> ‘‘(B) shall be taken into account in determining the
> basis of the property to which such grant relates, except
> that the basis of such property shall be reduced under
> section 50(c) in the same manner as a credit allowed under
> subsection (a).’’

ii. Energy Grant Should “Mimic” the Section 48 Credit

Section 1603(f) of the Act states that “[i]n making grants under this section, the Secretary of the Treasury shall apply rules similar to the rules of Section 50 of the [Code].”

The legislative history to Section 1603 of the Act states that “[i]t is intended that the grant provision mimic the operation of the credit under Section 48. For example, the amount of the grant is not includable in gross income. However, the basis of the property is reduced by fifty percent of the amount of the grant. In addition, some or all of each grant is subject to recapture if the grant eligible property is disposed of by the grant recipient within five years of being placed in service.” H. R. Rep No. 16, 111th Cong., 1st Sess. at 621 (2009).

Act Section 1603(f)’s requirement that rules “similar” to those in section 50, rather than “the rules of Section 50,” should apply indicates that Congress intended there be some variance between the application of section 50 in the case of the energy tax credit and the application of section 50 in the case of the Energy Grant. This same indication of Congressional intent is manifested in the ‘mimic’ standard noted in the legislative history. Had Congress intended the grant to be identical in amount to the section 48 credit amount, certainly Congress could have included such language.

It appears that the underlying policy of the Energy Grant was to create a program that economically encourages property owners of all stripes to invest in qualifying energy property. With enough critical mass, such investment is intended to help fuel the U.S. economy's growth, while reducing its reliance on foreign oil and helping to 'green' the U.S. Act Section 1603(f) and its legislative history should be read in a manner which better enable the intended objectives to be met.

B. To Provide the Greatest Incentive to Investment in Renewable Energy Projects, Guidance Should Clarify that Energy Grants Are Available to REITs Regardless of Taxable Income

Although energy tax credits can be useful in encouraging investment in renewable energy projects, REITs that distribute most of their income and taxpayers facing losses or reduced revenues due to the current economic crisis may not be sufficiently encouraged to invest in such projects. Because the Energy Grants are not dependent upon tax liability, presumably, the inclusion of the Energy Grant in the Act was meant to encourage such taxpayers, and others, to invest in renewable energy projects.

Furthermore, Act Section 1603(f)'s requirement that rules "similar" to those in section 50, rather than "the rules of Section 50," should apply to the rules governing the Energy Grants indicates that Congress intended there be some variance between the application of section 50 in the case of the energy tax credit and the application of section 50 in the case of the Energy Grant. As noted above, this same indication of Congressional intent is manifested in the 'mimic' standard noted in the legislative history. If Congress intended the grant to be identical in amount to the section 48 credit amount, certainly it could have stated such. Accordingly, based on the language of Act Section 1603(f) and its legislative history, and giving consideration to the analysis contained in this letter, we recommend that Act Section 1603(f) and its legislative history be read in a manner which better enables the intended objectives to be met.

As noted above, section 50 contains special rules for purposes of 'Computing the Investment Credit:'

- Section 50(a) addresses recapture.
- Section 50(b) addresses property not eligible for the credit.
- Section 50(c) addresses basis adjustment.
- Section 50(d) addresses 'certain rules made applicable' via seven subparagraphs, all of which refer to provisions in effect "on the day before the date of the enactment of the Revenue Reconciliation Act of 1990."

The Act's statutory language and/or its legislative history addresses all of the above specifically, with the exception of the limitations in section 50(d), which includes the limitation of the amount of Energy Credit available to REITs based on their taxable income. For example, recapture under section 50(a) is addressed in H. R. Rep. No. 111-16 at p. 621, where it specifically states that "some or all of the grant is subject to recapture if the grant eligible property is disposed of by the grant recipient within five years of being placed in service."

Section 50(b) is arguably modified by the Act's Section 1603(g). As discussed above, Act Section 1603(g) precludes certain persons from obtaining the Energy Grant, and appears to expand the applicability of certain provisions of section 50(b). For example, section 50(b)(3) relates to the 'use' of property by certain persons whereas Act Section 1603(g) appears to deny eligibility for the Energy Grant based on ownership by the listed persons. Further, section 50(b)(4)(D), relating to special rules for partnerships, appears to be either modified or superseded by Section 1603(g)(4) of the Act.

The basis adjustment rules of section 50(c) are dealt with by newly-enacted section 48(d)(3)(B), which provides that an Energy Grant "shall be taken into account in determining the basis of the property to which such grant relates, except that the basis of such property shall be reduced under section 50(c) in the same manner as a credit allowed under subsection [48](a).''

On the other hand, neither the Act nor its legislative history expressly addresses the seven subparagraphs of section 50(d). As noted *supra*, of these seven subparagraphs, only section 50(d)(1) has any relevance to REITs by referencing section 46(e) "as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990."

In the statutory language authorizing the Energy Grants, Congress provided a number of straightforward exceptions and limitations. For example, Section 1603(b)(3) of the Act explicitly provides for dollar limitations on the amount of Energy Grants. As noted above, Act Section 1603(g) explicitly excludes certain entities from being able to receive Energy Grants. On the other hand, Congress in Act Section 1603(f) only required that rules "similar" to those in section 50 apply to the Energy Grant. Clearly, if it had been Congress' intent for the amount of Energy Grants to REITs to be limited based on their taxable income, it seems that such a limitation could have easily been provided in either the statutory language or legislative history. However, neither the statute nor the legislative history expressly provides for a limitation on the amount of Energy Grants to REITs.

Given the negative impact of any limitation on the Energy Grant amount on the objectives embodied by Section 1603 of the Act and the ease in which such a limitation could have been imposed, the reference to using "similar" provision of section 50 (which in the case of section 50(d)(1) refers to section 46(e) as in effect "on the day before the date of the enactment of the Revenue Reconciliation Act of 1990") strongly suggests that Congress did not intend such a limitation.

To clarify that REITs may benefit from Energy Grants consistent with Congressional policy, the undersigned organizations respectfully request that the Treasury Department and IRS issue guidance clarifying that REITs are entitled to Energy Grants without regard to their taxable income.

C. <u>Tax-Exempt Entities Owning a *De Minimis* Interest in a Partnership Should Not Prevent a Partnership (or Other Pass-Thru Entity) From Receiving an Energy Grant</u>

As noted above, tax-exempt entities are not eligible for Energy Grants. Act Section 1603(f)(4) appears to indicate that even an infinitesimally small partnership interest owned by a tax-exempt entity could prevent the partnership from receiving any Energy Grant. In order to prevent a situation in which, for example, the transfer of a $100 partnership interest to a partner's section 401(k) plan could prevent a $10 billion partnership from receiving and putting to use an Energy Grant, we propose that the Treasury Department issue guidance clarifying that the ownership of less than 1% capital or profits interest in a partnership or pass-thru entity interest by any tax-exempt entity (including a federal, state, or local governmental entity)[3] should not disqualify the partnership or pass-thru entity from receiving an Energy Grant.

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Thank you for your consideration of this matter. Please feel free to contact Dara Bernstein at (202) 739-9446 or dbernstein@nareit.com to discuss these issues in greater detail.

Respectfully submitted,

American Hotel & Lodging Association
Building Owners and Managers Association International
International Council of Shopping Centers
NAIOP, the Commercial Real Estate Development Association
National Apartment Association
National Association of Real Estate Investment Trusts
National Multi Housing Council
The Real Estate Roundtable

[3] This situation could occur, for example, if a state government contributes a right of way to a partnership in exchange for a $1,000 partnership interest.

cc: Eric A. San Juan, Esq.
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Michael S. Novey, Esq.
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APPENDIX

Descriptions of Undersigned Organizations

Uniting 11,000 hospitality executives, the American Hotel & Lodging Association (AH&LA) is the only national organization dedicated to serving the interests of hoteliers on the front line, behind the scenes, and on Capitol Hill. Members are empowered with exclusive bottom line savings, educational resources, and networking opportunities with our expansive network of top-level industry professionals. AH&LA has been the leading voice of the lodging industry for nearly 100 years.

Founded in 1907, the Building Owners and Managers Association (BOMA) International is an international federation of more than 100 local associations and affiliated organizations. The 18,000-plus members of BOMA International own or manage more than 9 billion square feet of commercial properties in North America and abroad. BOMA's mission is to enhance the human, intellectual and physical assets of the commercial real estate industry through advocacy, education, research, standards and information.

The International Council of Shopping Centers (ICSC) is the premier global trade association of the retail real estate industry. Founded in 1957, ICSC has more than 70,000 members in the U.S., Canada, and over 90 other countries. ICSC represents owners, developers, retailers, lenders, and other professionals as well as academics and public officials.

NAIOP, the Commercial Real Estate Development Association, is the leading organization for developers, owners and related professionals in office, industrial and mixed-use real estate. NAIOP provides unparalleled industry networking and education, and advocates for effective legislation on behalf of our members. NAIOP advances responsible, sustainable development that creates jobs and benefits the communities in which our members work and live.

The National Association of Real Estate Investment Trusts (NAREIT) is the representative voice for U.S. REITs and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

The National Multi Housing Council (NMHC) and the National Apartment Association (NAA) represent the nation's leading firms participating in the multifamily rental housing industry. Their combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management, and finance. The National Multi Housing Council represents the principal officers of the apartment industry's largest and most prominent firms. The National Apartment Association is the largest national federation of state and local apartment associations. NAA is comprised of nearly 200 affiliates and represents over 51,000 professionals who own and manage more than 6 million apartments. NMHC and NAA jointly operate a federal legislative program and provide a unified voice for the private apartment industry.

The Real Estate Roundtable (Roundtable) provides a forum for top U.S. real estate and political leaders to discuss major policy issues and their implications for real estate and the economy. Collectively, Roundtable members' portfolios contain over 5 billion square feet of office, retail and industrial properties valued at more than $1 trillion; over 1.5 million apartment units; and in excess of 1.3 million hotel rooms. Participating trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business.