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

January 29, 2009

VIA E-MAIL AND U.S. MAIL

Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-130342-08)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20024

Re: Comments in Response to IRS Announcement 2008-115

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity to offer our comments as to whether the regulations under section 897¹ should be revised to treat certain governmental permits as United States real property interests (USRPIs), as defined in section 897(c). NAREIT is the representative voice for U.S. real estate investment trusts (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.

EXECUTIVE SUMMARY

First, NAREIT is pleased that the Treasury Department and the Internal Revenue Service (IRS) are addressing the issue of whether certain governmental permits required in the course of construction, operation and maintenance of certain infrastructure assets constitute USRPIs. NAREIT recognizes the government's interest in increasing private investment in infrastructure and welcomes any regulatory guidance that encourages infrastructure investments, whether from domestic or non-U.S. sources.

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



Accordingly, NAREIT recommends that, to the extent that any guidance under this regulatory project is issued that does not treat such governmental permits as USRPIs under section 897(c), the guidance nevertheless should treat such items as “real estate assets” under section 856(c)(5)(B) for REIT purposes in order to prevent hindrances to REIT investment in infrastructure. Further, to the extent that any guidance under this regulatory project is issued that does treat such governmental permits as USRPIs under section 897(c), the guidance also should treat such items as “real estate assets” under section 856(c)(5)(B) for REIT purposes.

So long as the government is addressing what constitutes real estate (at least with respect to infrastructure), NAREIT specifically requests that the Treasury Department and IRS amend the withholding regulations under section 1445 that implement the Foreign Investment in Real Property Tax Act (FIRPTA) taxation regime of section 897 to clarify that they require FIRPTA withholding only with respect to distributions to non-U.S. shareholders of gains attributable to a REIT’s dispositions of USRPIs.

As you know, under section 897, gains realized from the dispositions of USRPIs by nonresident aliens or non-U.S. corporations generally are treated as income effectively connected with a trade or business. In the case of REITs, section 897(h)(1) provides that distributions attributable to gain from a REIT’s disposition of USRPIs are treated as effectively connected gain. Section 1445(e)(6) and Treas. Reg. § 1.1445-8 implement this taxation regime by means of a withholding tax on REIT “capital gain dividends” distributed to certain non-U.S. shareholders. Yet, as further described below, even though a REIT’s capital gain dividend may or may not represent a distribution of gains attributable to the REIT’s disposition of a USRPI, Treas. Reg. § 1.1445-8(c)(2)(ii)(C) imposes a withholding tax of 35% on the maximum amount a REIT could designate as a capital gain dividend. For example, a REIT’s gain from the disposition of obvious non-real estate items such as medical equipment (generally disposed of separately from any associated real property) or Treasury bonds clearly would not be considered gain from the disposition of USRPIs as to the distributee foreign shareholder of the REIT. Nonetheless, under the current regulations, arguably the REIT would be required to withhold 35% of such amount even to the extent attributable to non-USRPIs.

Furthermore, because section 1445(e)(6) (the only statutory provision specifically requiring REITs to withhold on distributions of gains from USRPIs to non-U.S. shareholders) mandates withholding only on gains attributable to the dispositions of USRPIs, the current regulations appear to go beyond the scope of the statute and should be clarified. Thus, this letter requests that the Treasury Department and the IRS amend the regulations under Treas. Reg. § 1.1445-8(c) to make it clear that only capital gain dividends that are attributable to gain from a REIT’s disposition of USRPIs are subject to withholding under section 1445.



DISCUSSION

I. REITs and FIRPTA: Substantial, But Not Complete, Overlap

A. REITs

As provided in Subchapter M of the Code, REITs are business entities taxable as domestic corporations that satisfy a myriad of requirements designed to ensure that they are real estate focused. At the same time, the provisions of Subchapter M also make it clear that both a REIT's assets and gross income may consist of a **limited** number and amount of items that have nothing to do with U.S. real estate without jeopardizing the entity's qualification as a REIT. For example, a REIT that owns millions of dollars of real estate also may own a car worth thousands of dollars or a treasury bond worth hundreds of thousands of dollars. As further described below, REITs also may recognize gains from the sales of items that qualify as "real estate assets" under the REIT rules but are not USRPIs under the FIRPTA rules (for example, U.K. real estate).

In order to ensure that they remain real estate-focused, REITs must satisfy quarterly asset tests (the Asset Tests) and annual income tests (the Income Tests). If they satisfy the Asset Tests, Income Tests, distribute at least 90% of their taxable income, and satisfy a variety of other compliance requirements, REITs are entitled to claim a deduction for dividends paid (DPD). As a result, the income and gain of most qualifying REITs are generally taxed solely at the shareholder level. Although REITs are not required to distribute net capital gains, they pay corporate-level tax on such amounts if retained. Accordingly, REITs may designate capital gain dividends and distribute such amounts to shareholders, who then treat the amounts designated as capital gain on their tax returns. Section 857(b)(3).

A capital gain dividend is defined in section 857(b)(3)(C) as

any dividend, or part thereof, which is designated by the [REIT] as a capital gain dividend in a written notice mailed to its shareholders . . . at any time before the expiration of 30 days after the close of its taxable year. . . . If the aggregate amount so designated [as a capital gain dividend] is greater than the [REIT's] net capital gain of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only be that proportion of the amount so designated which such net capital gain bears to the aggregate amount so designated.

Thus, a REIT's capital gain dividends cannot exceed its net capital gain for the year.



1. The Asset Tests

Section 856(c)(4) requires that, at the end of each calendar quarter,

- 1) at least 75% of the value of a REIT's assets must be comprised of real estate assets, cash and cash items, and Government securities;
- 2) not more than 25% of the value of a REIT's assets may be represented by other securities; and
- 3) not more than 25% of the value of its assets may be represented by the securities of one or more "taxable REIT subsidiaries" (TRSs).

In general, a TRS is a fully taxable corporation the securities of which are owned in whole or in part by a REIT and with respect to which the REIT and TRS make a TRS election. Other than actually operating health care and lodging facilities, a TRS can engage in virtually any activity. Many REITs use TRSs to provide services ancillary to a particular REIT's business of owning and operating real estate, such as landscaping, shuttle bus services, and concierge services. REITs that own certain health care and lodging facilities also may lease qualifying properties to their TRSs and receive qualifying gross income from them.

Section 856(c)(5)(B) defines "real estate assets" as

real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other [REITs]. Such term also includes any property (not otherwise a real estate asset) attributable to the temporary investment of new capital, but only if such property is stock or a debt instrument, and only for the 1-year period beginning on the date the real estate trust receives such capital.

Securities of a TRS, while permissible for REITs to own, are not typically "real estate assets."

Under Treas. Reg. § 1.856-3(d), the term "real property" means

land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term "real property" includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 856 and the regulations there under. The term includes, for example, the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc. even though such items may be termed fixtures under local law.



The IRS has interpreted these provisions in a number of relevant areas. For example, the IRS held in PLR 9843020 that permits to operate a ski resort on government property are “real estate assets” and “interests in real property” under section 856(c) because they entitle the holder to a long-term interest in real property. *See also* PLRs 200039017 (concession agreement granting 30-year right to occupy and operate airport parking facilities equivalent to a lease and therefore a “real estate asset”); 200705013 (“concession agreement” granting entity long-term right to construct and use specified real estate to operate and maintain a retail and entertainment complex equivalent to a lease and therefore a “real estate asset”); and 200813009 (“real estate intangibles” treated as “real estate assets” to the extent inextricably linked to the underlying real estate). Furthermore, in Rev. Rul. 74-191, 1974-1 C.B. 170, the IRS held that otherwise qualifying assets do not fail to satisfy section 856(c)(4) merely because the assets are foreign.

2. The Income Tests

Section 856(c)(3) and (c)(2) contain the REIT Income Tests. In general, under section 856(c)(3), at least 75% of a REIT’s annual gross income (excluding gross income from prohibited transactions) must be derived from rents from real property; interest on obligations secured by mortgages on real property or on interests in real property; gain from the sale or other disposition of real property; and similar real estate-related items. Under section 856(c)(2), at least 95% of a REIT’s annual gross income must consist of those items included under section 856(c)(3), as well as other types of passive income, such as interest and dividends unrelated to real property or interests in real property.

B. FIRPTA

1. Generally

Non-U.S. persons typically are not taxed on U.S. source capital gains unless certain physical presence or “effectively connected” income requirements are satisfied. However, under FIRPTA, special tax rules apply to the gains of non-U.S. persons that are attributable to dispositions of USRPIs. Section 897(a) generally treats such gain as effectively connected income subject to tax at the same rates applicable to a U.S. person.

2. Definition of USRPI

Section 897(c)(1)(A) defines a USRPI to mean: i) an interest in real property located in the United States or the Virgin Islands; and, ii) any interest (other than an interest solely as a creditor) in a domestic corporation that is a United States real property holding corporation (USRPHC).

a. “Interest in Real Property” Defined

Treas. Reg. § 1.897-1(d)(2)(i) provides that an interest in real property other than solely as a creditor includes a fee ownership, co-ownership, or leasehold interest in real property, a time sharing interest in real property, and a life estate, remainder, or reversionary interest in real



property. The term also includes any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property.

Treas. Reg. § 1.897-1(d)(4)(ii)(A) provides that personal property that has become associated with the use of a real property interest will not be treated as a real property interest upon its disposition so long as: 1) there is over one year between the disposition of the personal property and the disposition of the rights to use and occupy the associated real property; or, 2) the disposition of the personal property and rights to use or occupy the associated real property are made to persons unrelated to the transferor and to one another.

b. USRPHC Defined

In addition to an interest in real property located in the United States or the Virgin Islands, under section 897(c)(1)(A)(ii), USRPIs include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during the 5-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which, under section 897(c)(2) is defined generally to mean any corporation the fair market value of whose U.S. real property interests equals or exceeds 50% of the sum of the fair market values of its U.S. real property interests, its interests in real property located outside of the U.S., plus any other of its assets used or held for use in a trade or business).

3. Incomplete Overlap Between Definitions of “Real Estate Asset” and “USRPIs”

As demonstrated by the above discussion, while there is significant overlap between the definition of “real estate asset” for purposes of the REIT rules and the definition of USRPI under the FIRPTA rules, there is not complete overlap. The following chart illustrates this principle more clearly:



Type of Property	Can Consist of What Percentage of REIT's Total Assets?	"Real Estate Asset"?	"USRPI"?
1) Fee ownership of U.S. real property	100%	Yes	Yes
2) Leasehold ownership of U.S. real property	100%	Yes	Yes
3) Debt, solely as a creditor, secured by mortgage on U.S. real property	100%	Yes	No
4) Medical equipment (so long as not associated with real property)	25%	No	No
5) Fee ownership of non-U.S. real property	100%	Yes	No
6) Securities in a TRS	25%	No	Typically No, but some TRSs that lease hotels or health care facilities or develop U.S. properties may be USRPHCs (thus, shares of these entities would be USRPIs)
7) Government securities	100% ²	No	No

Thus, gain attributable to the disposition of a "real estate asset," such as foreign real estate, will not necessarily be considered gain from the disposition of a USRPI. Similarly, gain from the disposition of non-real estate, but permitted, assets also will not be considered gain from the disposition of a USRPI.

4. Applicability of FIRPTA to REIT Distributions: Sections 897(h) and 1445(e)(6)

Section 897(h)(1) provides that any distribution to a non-U.S. person (or conduit therefor) by, among others, a REIT, shall, to the extent attributable to gain from the sale or exchange by the REIT of a USRPI, be treated as gain recognized by such nonresident alien individual, foreign

² If Government securities constitute a high percentage of a REIT's assets, the REIT may have difficulties satisfying the REIT Income Tests.



corporation, or other qualified investment entity from the sale or exchange of a USRPI.³ Thus, such distributions are taxable to such nonresident alien individual or foreign corporation under section 897(a)(1).

a. Generally

In order to collect the FIRPTA tax liability, section 1445 imposes a withholding tax on many transactions relating to the disposition of a USRPI. For example, section 1445(a) imposes a 10% withholding tax on the amount realized by a foreign person on the disposition of a USRPI. Section 1445(e)(3) applies to redemptions and dividends in excess of earnings and profits distributed by USRPHCs to foreign shareholders and requires withholding of 10% of the amount realized by the foreign shareholder.

b. REITs

Until 2006, section 1445 did not contain a specific provision addressing distributions to foreign shareholders by REITs which, pursuant to section 897(h), were treated as gain realized by the foreign shareholder attributable to the dispositions of USRPIs. The closest relevant provision of section 1445 was perhaps section 1445(e)(3), which imposed a withholding tax on a USRPHC with respect to distributions to foreign shareholders in redemption and/or with respect to dividends in excess of earnings and profits. Section 1445(e)(3) thus would apply to such distributions by a REIT that invested in U.S. real property, but not necessarily by a REIT that invested in mortgages secured by U.S. real property or mostly foreign real property. The Code also contained section 1445(e)(1), relating to distributions by U.S. partnerships, trusts and/or estates to foreign interest holders allocable to gain attributable to such entity's disposition of USRPIs, and section 1445(e)(4), relating to distributions of USRPIs by such entities. However, inasmuch as a U.S. REIT is none of these entities, none of such provisions should have been read as authorizing withholding obligations on REITs under section 1445.

Nevertheless, the IRS first issued regulations requiring section 1445 withholding by REITs with respect to distributions to foreign shareholders under the authority of Sections 1445(e)(1) and (e)(4) in 1984 as temporary (T.D. 8000), and final (T.D. 7999), regulations. Following public comment, these regulations were amended, and the IRS issued final regulations in 1990 (T.D. 83210).

In response to comments regarding the unworkability of the earlier regulations, the amended final regulations first provide that “[a REIT] is liable to withhold tax upon the **distribution of any amount attributable to the disposition of a [USRPI].**” Treas. Reg. § 1.1445-8(b)(1). (Emphasis added.) However, the final regulations then go on to require a REIT to withhold 35% of its net capital gain distributions.⁴ Treas. Reg. § 1.1445-8(c)(2). However, these regulations arguably do not appear to limit withholding to net capital gain distributions attributable to the

³ The second sentence of Section 897(h)(1), added in 2004, provides that capital gain distributions by publicly traded REITs to shareholders owning 5% or less of the REIT are treated as ordinary dividends. This letter deals solely with distributions not covered by the second sentence of Section 897(h)(1).

⁴ This percentage was increased from 34% to 35% pursuant to regulations issued in 1995 (T.D.8647).



disposition by a REIT of USRPIs.⁵ Thus, Treas. Reg. § 1.1445-8(c)(2) arguably could be read as inconsistent with § 1.1445-8(b)(1). If so, Treas. Reg. § 1.1445-8(c)(2) would be extending beyond the scope of section 1445(e)(6). It would be helpful if the IRS and Treasury amended Treas. Reg. § 1.1445-8(c)(2) to clarify that it applies only to REIT capital gain dividends attributable to gains from the disposition by a REIT of USRPIs.

These final regulations also provide that the largest amount of any distribution that could be designated as a capital gain dividend will be deemed to have been designated by the publicly traded REIT as a capital gain dividend for purposes of Treas. Reg. § 1.1445-8, thereby making it automatically subject to withholding under Treas. Reg. § 1.1445-8. The preamble to the final 1990 regulations stated the following reason for doing so:

The elimination of the preferential rate for net capital gains may remove an incentive for REITs to designate capital gain dividends. In this context it should be observed that, under the rules of the proposed and temporary regulations, FIRPTA withholding would be avoided if no portion of a dividend were designated as a capital gain dividend. . . . If, subsequent to these regulations, **a provision for preferential treatment is enacted for net capital gains, the deemed capital gain dividend provision in section 1.1445-8(c)(2)(ii) will be amended in accordance with and to reflect the enactment of such preferential treatment.** (Emphasis added.)

In fact, Congress enacted preferential treatment for capital gains in 2003 under The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, Pub.L. 108-27); thus, by the IRS' clearly articulated recognition, the regulations under Treas. Reg. § 1.1445-8 concerning REIT distributions should be amended.

In 2006, Congress added new subsection (e)(6) to Section 1445, explicitly requiring withholding by REITs (and mutual funds, whose dispositions attributable to their dispositions of USRPIs also became subject to section 897(h) in 2006). Section 1445(e)(6) provides:

If any portion of a distribution from a [REIT] to a nonresident alien individual or a foreign corporation is treated under section 897(h)(1) as gain realized by such individual or corporation from the sale or exchange of a United States real property interest, the [REIT] shall deduct and withhold under subsection (a) a tax equal to 35 percent (or, to the extent provided in Regulations, 15 percent (20 percent in the case of taxable years beginning after December 31, 2010)) of the amount so treated.

⁵ NAREIT first made the suggestion that the withholding on net capital gain distribution be so limited in testimony at an IRS public hearing on then Treas. Reg. § 1.1445-5T(c)(4) on Jan. 17, 1986. (Prepared Testimony of NAREIT before the IRS on Treas. Reg. § 1.1445-5T(c)(4), footnote 2, page 11 (Jan. 17, 1986).) Unfortunately, the suggestion was not explicitly adopted at the time the amended regulations were finalized.



II. Because Capital Gains Dividends Do Not Necessarily Reflect Distributions of Gains from a REIT's Disposition of USRPIs, Treas. Reg. § 1.1445-8 Should Be Amended to Clearly Implement Sections 897(h) and 1445(e)(6)

Treas. Reg. § 1.1445-8(c) could be read as not implementing sections 897(h) and 1445(e)(6), as its application could very easily result in either overwithholding or underwithholding. Capital gain dividends do not necessarily represent distributions of gain attributable to a REIT's disposition of USRPIs. As a simple example of how Treas. Reg. § 1.1445-8 could be overly inclusive, a REIT's capital gain dividend could include gain from the REIT's disposition of medical equipment (not associated with real property), foreign real estate, a Treasury security, or mortgages on real property representing debt held solely as a creditor, all of which are permitted REIT assets. None of this gain would be representative of gain from the REIT's disposition of a USRPI.

On the other hand, application of Treas. Reg. § 1.1445-8 could result in underwithholding in the case of distributions by the REIT representing only short-term gain from the disposition of USRPIs. Treas. Reg. § 1.1445-8(c)(2)(ii)(B) considers this issue "reserved." Admittedly, because REITs are required to be long-term investors in real estate, they may not realize much short-term gain. Nonetheless, because of market circumstances, some REITs may realize gain on the sale of assets held for less than one year. Presumably, distribution of such gain to certain foreign shareholders would be treated under section 897(h) as gain from the disposition of USRPIs by them. Since under section 857(b)(3)(C), a capital gain dividend cannot exceed a REIT's "net capital gain" for the year, and since a REIT will only have "net capital gain" to the extent it has long-term capital gains, a REIT distribution representing only short-term capital gains definitionally cannot be considered a capital gain dividend.⁶

Few would argue that the Code authorizes the IRS to require section 1445 withholding on all REIT capital gain dividends. On the other hand, section 1445(e)(6) of the Code does require a REIT to withhold on distributions of gain attributable to dispositions of USRPIs. Thus, REITs attempting to withhold the correct amount under section 1445(e)(6) could be compelled to overwithhold and/or underwithhold under Treas. Reg. § 1.1445-8. Theoretically, foreign shareholders could apply for refunds of overwithheld amounts. However, at a time when access to capital is so limited, the Treasury Department and IRS should consider taking steps to clearly set forth the correct withholding amounts by U.S. companies.

In order for the IRS to implement sections 1445(e)(6) and 897(h), it should amend Treas. Reg. § 1.1445-8 to clarify that withholding is required only on distributions by REITs to foreign shareholders (other than 5% or less shareholders of publicly traded REITs described in the second sentence of section 897(h)) that are attributable to dispositions by the REIT of USRPIs. NAREIT would be pleased to work with the Treasury Department and IRS to develop appropriate provisions.

⁶ Presumably, distributions of short-term capital gains, to the extent attributable to current and/or accumulated earnings and profits, would be subject to withholding as ordinary dividends under Section 1441. However, without such earnings and profits (e.g., if the REIT has a net operating loss), no withholding would be required.



Another reason for the Treasury Department and IRS to consider amending Treas. Reg. § 1.1445-8 would be to reflect the reduction in capital gains tax rates enacted in 2003 under JGTRRA. Section 1445(e)(6) reflects Congress' awareness of potential overwithholding by suggesting that the regulations implement a lower withholding rate than 35%. Doing so would be consistent with the preamble to the final Treas. Reg. § 1.1445-8.

Finally, as we have previously communicated to you, we support the recommendations of changes to the FIRPTA regulations suggested by the American Bar Association in a June 10, 2008 submission letter.

Thank you for your consideration of this matter. Feel free to contact me or Dara Bernstein, NAREIT's Senior Tax Counsel, if you would like to discuss these issues in greater detail.

Respectfully submitted,



Tony M. Edwards
Executive Vice President & General Counsel

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