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October 31, 2006

The Honorable Charles E. Grassley
Chairman
Committee on Finance
U.S. Senate
Washington, D.C. 20510

The Honorable Max Baucus
Ranking Member
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Re: Comments on S. 4026, the Tax Technical Corrections Act of 2006 (TTCA 2006)

Dear Chairman Grassley and Ranking Member Baucus:

In response to the Committee's request, dated September 29, 2006, for comments on the Tax Technical Corrections Act of 2006 (S. 4026) and proposals for additional technical corrections, we respectfully request that you consider including in the bill a new provision that would clarify the application of the "transient basis" test that is used to define a "lodging facility" in section 856(d)(9)(D)(ii) for purposes of the real estate investment trust ("REIT") rules regarding taxable REIT subsidiaries ("TRS").[1]

We are submitting this request on behalf of Extended Stay, Inc. ("ESI"), which is a hospitality industry REIT with over 600 lodging properties located across the United States—approximately 550 of which are owned by ESI and leased to TRSs. As its name suggests, ESI specializes in a hospitality market segment that consists of longer term (but nevertheless temporary) occupancies. As discussed more fully below, a clarification of the TRS transient basis test would address an area of significant uncertainty for all hospitality industry REITs that utilize a TRS structure.

BACKGROUND

To qualify as a REIT, an entity must derive at least 95 percent of its gross income from sources listed in section 856(c)(2) and at least 75 percent of its gross income from sources listed in section 856(c)(3). Although rents from real property generally are treated as qualifying income for purposes of these tests, income from providing hotel accommodations to guests is not treated as qualifying income due to the service element associated with providing hotel accommodations. However, the REIT rules provide that a REIT's gross income derived from a hotel property can be treated as qualifying income if the REIT leases the hotel property to a third party operator or a TRS (which, in turn, must contract with a third party to operate the property).

[1] Unless otherwise noted herein, all references to "section" are to the Internal Revenue Code of 1986, as amended (the "Code").

The lease payments from a TRS to the REIT under such an arrangement are treated as rents from real property (i.e., qualifying income under the REIT income tests), provided the leased property constitutes a "lodging facility" (among other requirements). Section 856(d)(9)(D)(ii) defines a "lodging facility" as a "hotel, motel, or other establishment more than one-half of the dwelling units in which are used on a transient basis." The term "transient basis" is not defined in section 856 or any regulations thereunder, notwithstanding the fact that a failure to satisfy the transient basis test could result in a loss of REIT status.

In the aftermath of Hurricanes Katrina and Rita last year, the hospitality industry provided (and continues to provide) lodging for evacuees, employees of displaced businesses, and relief workers for extended periods of time. To assist hospitality industry REITs in meeting these critical housing needs without impacting their compliance with the transient basis test, the Internal Revenue Service (the "IRS") issued two notices providing a limited and temporary clarification of the transient basis test.

The IRS announced in Notice 2005-89, 2005-49 I.R.B. 1077, that, for purposes of the "lodging facility" definition under section 856(d)(9)(D)(ii), it would treat a dwelling unit within a property as being used on a transient basis if the unit was used to provide shelter to evacuees, displaced employees or relief workers during the 6-month period beginning on August 28, 2005 (the date of the President's first major disaster declaration resulting from Hurricane Katrina). Due to the magnitude of the damage resulting from Hurricanes Katrina and Rita, the IRS later extended and modified this guidance with the issuance of Notice 2006-58, 2006-28, I.R.B. 59. **In both Notices, the IRS acknowledged that "Section 856 and the regulations thereunder do not define the term 'transient basis'."**

PERMANENT CLARIFICATION OF THE TRANSIENT BASIS TEST

While the IRS Notices provided welcome and needed clarification of the section 856(d)(9)(D)(ii) transient basis test under extenuating circumstances, this clarification is only temporary and limited to occupancies related to Hurricanes Katrina and Rita. As an addition to the pending technical corrections bill, we respectfully request that the application of the section 856(d)(9)(D)(ii) transient basis test be clarified permanently and generally, either by providing a 6-month quantitative standard for the test (Alternative #1) or by clarifying that the transient basis test does not apply to properties that are hotels or motels (Alternative #2).

Alternative #1—Clarify that the transient basis test is applied using a six (6)-month period.

While other Code sections employ variations of the transient basis test,[2] there is no consistent definition of what constitutes a transient basis. In fact, we are aware of only a few instances in which such a definition has been provided.[3]

The term "transient basis" is used in section 42(i)(3)(B)(i) which, for purposes of the low-income housing credit, defines a "low-income unit" as any unit that (among other things) is "used other than on a transient basis." As is the case with regard to section 856(d)(9)(D)(ii), neither section 42 nor the regulations thereunder define the term "transient basis". However, legislative history discussing the low-income housing credit indicates that transient basis use of a unit refers to occupancy periods of less than six months: "Generally, a unit is considered to be used on a nontransient basis if the initial lease term is six months or greater." H.R. Conf. Rep. No. 99-841, at 4183 (1986).

We believe that the uses of the term "transient basis" in the section 42 low-income housing credit and in the section 856 REIT TRS rules serve the same purpose. In both cases, the term is intended to distinguish between property which is used to provide temporary lodging for guests and property which is used to provide permanent housing for residents. Therefore, if a quantitative standard is used to clarify the application of the transient basis test in determining whether property constitutes a "lodging facility" under section 856(d)(9)(D)(ii), we would suggest using the same 6-month standard that is used in determining whether a unit is a low-income unit for purposes of the low-income housing credit. **This clarification also would be consistent with the temporary and limited clarification that was provided in the IRS**

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[2] For example, under the investment credit recapture rules of section 50(b)(2)(B), property used for lodging is not eligible for the credit except for "property used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients." Another example of the transient basis test can be found in the accelerated cost recovery system depreciation rules of section 168. In distinguishing between an apartment lodging facility, which qualifies as residential rental property with a 27.5-year recovery period, and a hotel/motel, which does not qualify as residential rental property (and has a 39-year recovery period), section 168(e)(2)(A)(i) provides that the term "residential rental property" means any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. For this purpose, section 168(e)(2)(A)(ii)(I) provides that the term "dwelling unit" means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis.

[3] *See, e.g.*, former Treas. Reg. section 1.167(k)-3(c) and Treas. Reg. section 1.48-1(h)(2)(ii). These regulations provide (or provided) that a facility is treated as used on a transient basis if the facility is used more than 50 percent of the time for occupancies of less than 30 days. Although section 48 itself was repealed in 1990, the Treasury regulations under section 48 (including Treas. Reg. section 1.48-1(h)(2)(ii)) have never been removed.

Notices relating to Hurricanes Katrina and Rita, which itself presumably found support from the low-income housing credit for using a 6-month period.

Proposed language—Under Alternative #1, Section 856(d)(9)(D)(ii) would be amended to read to as follows:

> "(ii) LODGING FACILITY.—The term 'lodging facility' means a hotel, motel, or other establishment more than one-half of the dwelling units in which are used by persons who occupy the unit for less than 6 months."[4]

Alternative #2—Clarify that the transient basis test applies only to establishments other than hotels and motels.

Beyond the absence of a definition of the term "transient basis", the scope of application of the transient basis test for purposes of section 856(d)(9)(D)(ii) is unclear with regard to whether the test even applies to properties that are hotels or motels. The relevant statutory language of section 856(d)(9)(D)(ii)—"hotel, motel, or other establishment more than one-half of the dwelling units in which are used on a transient basis"—could be interpreted as providing that the transient basis test only applies to "other establishment[s]" and not to hotels or motels, particularly since the terms "hotel" and "motel" would appear to be surplusage if, instead, the transient basis test applies to all properties without regard to whether they are "hotels", "motels" or "other establishment[s]".[5]

Such an interpretation does place some definitional pressure on the terms "hotel" and "motel". However, these terms are used in several other Code sections, often without any accompanying definitional detail.[6] With regard to whether a property constitutes a "lodging facility" under section 856(d)(9)(D)(ii), we believe that the plain meaning of these terms is sufficiently clear in the vast majority of circumstances without the need for further statutory

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[4] The proposed language eliminates any reference to the term "transient basis" because a quantitative standard would supplant the need to use the term, thereby avoiding any unintended interpretive consequences for other Code sections that use the term. A further refinement to the proposed language also might eliminate the terms "hotel" and "motel" as surplusage if the transient basis test applies to all "establishments" without regard to whether they are hotels or motels.

[5] *See* Lawrence Filson, *The Legislative Drafter's Desk Reference*, Congressional Quarterly, Inc. (1993), at 234 ("When setting forth a series of items in a sentence either in conjunctive or disjunctive form, the last two items in the series, like the earlier items, should be separated by a comma. ... The omission of the final comma in the series—a common practice in expository writing—sometimes invites the misreading that the last item is part of the preceding one....").

[6] *See* former section 48(a)(3)(B) and sections 50(b)(2)(B), 168(e)(2)(A)(ii)(I), 179D(f)(2)(C)(i), 280A(f)(1)(B), 1202(e)(3)(E), and 3121(d)(3)(D).

definition. Even in the handful of cases in which there might be some factual question concerning whether a particular property constitutes a hotel or motel, there are certain distinctive features of hotels and motels that can be identified and an analysis of the property in question performed to determine whether the property possesses the requisite characteristics of a hotel or motel.

For example, hotels and motels may be subject to applicable local occupancy taxes that do not apply to residential property, and their sites generally are zoned specifically for use by a hotel or motel. In addition, the nature of the contractual relationship between the provider and occupant of the dwelling units in question (i.e., guest registration versus negotiated lease) may be determinative of this issue.

While there may be a few isolated situations in which the terms "hotel" and "motel" by themselves are somewhat ambiguous and pose some interpretive difficulty, the statutory language of section 856(d)(9)(D)(ii) at least should be more clear about whether properties that are hotels or motels also must satisfy the transient basis test. If hotels and motels are required to satisfy the transient basis test, then we believe that the transient basis test itself needs to be more clearly defined, as proposed by Alternative #1 above. If not, then we believe that section 856(d)(9)(D)(ii) needs to be restated to clarify that the transient basis test applies only to "other establishment[s]" and not to "hotels" or "motels". The proposed language below would accomplish this by simply dividing the clause into separate subclauses.

Proposed language—Section 856(d)(9)(D)(ii) would be amended to read as follows:

"(ii) LODGING FACILITY.—The term 'lodging facility' means—
- (I) a hotel or motel, or
- (II) any other establishment more than one-half of the dwelling units in which are used on a transient basis."

* * *

We appreciate your consideration of our request to clarify the section 856(d)(9)(D)(ii) transient basis test in the pending technical corrections legislation. We would be happy to meet with you to discuss this issue further. Please feel free to contact us at (202) 344-4034 (Sam Olchyk) or (202) 344-4406 (Ray Beeman).

Sincerely yours,

Sam Olchyk

E. Ray Beeman

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