MULTISTATE TAX COMMISSION

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To: MTC Income Tax Uniformity Subcommittee and Drafting Group

From: Bruce Fort, Counsel, MTC

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Subject: Status Report on Captive Regulated Investment Companies Model Statute

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Beginning in early 2006, the Income Tax Uniformity Subcommittee began consideration of legislative solutions to the problems presented by the use of certain controlled ("captive") pass-through entities as a tax planning mechanism to allow double deductions of income or to avoid income taxation. The project was partly an outgrowth of a special interagency task force formed in 2004 to address tax shelter activities. In particular, the Income Tax Uniformity Subcommittee focused on the use of captive Real Estate Investment Trusts (REITs) and captive Regulated Investment Companies (RICs), not as investment vehicles for small shareholders, but as a means of achieving unintended state tax reductions. Although similar in their federal and state tax structures, captive RICs and REITs present different challenges for state tax administrators because of the different nature of the properties they hold.

In November of 2006, the Subcommittee voted 17-0 to bifurcate the drafting efforts. Since that time, a proposed "Captive REIT" statute has been drafted and has been approved by the Income Tax Uniformity Subcommittee and Executive Committee and has received a public hearing. The Uniformity Committee has advanced the captive REIT project relatively quickly in part because several state legislatures have passed legislation addressed to captive REITs and other states are contemplating similar legislation, heightening the need for a uniform law. The captive RICs issue has not received the same attention by state legislatures, perhaps because it is a planning device available to fewer taxpayers. The Subcommittee further agreed to limit drafting efforts to captive REITs and RICs in lieu of addressing more general concerns with the use of pass-through entities to eliminate some source-based taxation.

Regulated Investment Companies (RICs):

A RIC is a domestic corporation that pools investments from more than one hundred persons for the purpose of investing in securities. RICs were established by the federal Investment Company Act of 1940 as a way for smaller investors to secure the benefits of professional management and a more diversified securities portfolio. A RIC must derive at least 90% of its income from dividends, interest, loan repayments and gains from the sale of stocks; it cannot have more than 25% of its portfolio invested in a single company or affiliated group of companies. A RIC is a pass-through entity that must distribute 90% or more of its income to shareholders, and is subject to tax on any remaining income unless 98% of that income is distributed. See 26 USC 851 et seq. The Internal Revenue Code grants RICs a dividends paid deduction (DPD) and imposes tax on the dividend recipient. See 26 U.S.C. § 852(a) and 852(c).

Problem #1: The Double Deduction Problem

Some states have discovered that dividends received from RICs and REITs are afforded a double-deduction because states generally conform to federal taxable income standards but some states de-conform with respect to taxation of dividends received from domestic and foreign sources. Thus, RIC and REIT income may escape state taxation entirely because there is both a DPD and a dividends received deduction (DRD) at the state level. California, Massachusetts and New Jersey have now amended their statutes or regulations to fix the double-deduction problem; and Massachusetts has prevailed in arguing that the legislature did not intend to allow a double-deduction for REIT dividends even before the legislative fix. *Fleet Funding v. Commissioner* (2007*).* The MTC's proposed REIT statute and drafting efforts so far with respect to RICs have not addressed the problems arising from non-conformity with federal treatment of dividends from pass-through entities.

Problem #2: The Nexus Problem for RIC's

The Income Tax Uniformity Subcommittee expended considerable efforts in determining how to impose an effective tax on income earned by RICs and settled on a similar solution to that proposed for REIT's: reversal of the federal dividends paid deduction for those entities. The product of those efforts is a draft statute attached hereto as Appendix A. That model should prove effective for combined filing states concerned by the practice of financial institutions and others of establishing RICs with dividend recipients who are outside the combined group, e.g., 80/20 companies and captive insurance companies.

Appendix B consists of excerpts from New York's recent statute providing for mandatory combination of captive RICs and REITs. The statute is lengthy and complicated, but it provides a possible model for states in which there may be some uncertainty with respect to whether a particular RIC or REIT would fall within the combined filing group.

The MTC model attached as Appendix A and the New York model attached as Appendix B do not address any potential problems with properly sourcing the RIC income, especially where income from the assets transferred to the RICs would otherwise be sourced according to cost of performance and market considerations. It is now clear that many financial institutions have established captive RICs in Nevada and other states which do not impose income-based taxes. Applying the cost of performance and market rules of the MTC model regulation for apportionment of financial institutions to captive RICs would likely lead to incongruous results in comparison with application of that regulation to interest and similar income from the underlying debt instruments. Depending on the methods utilized by combined filing states for sourcing intangible income, captive RICs can create anomalous sourcing outcomes for income from treasury investments, working capital, hedging transactions and similar transactions.

The nexus problem affects separate entity states more than it does combined reporting states. In a separate entity state, income earned from intangible assets transferred to a captive RIC would likely escape taxation altogether. The draft statute developed so far would likely have no benefit for separate entity states.

The drafting committee considered several other approaches to the RIC problem, including forced combination of the RICs, withholding taxes on the RICs, and denial of a dividends-received deduction for indirectly-received dividends. Each of these approaches will be discussed briefly below:

1. Denial of Dividends-Received Deduction for indirect dividends. It appears that a common use of the REIT/RIC strategy involves payment of taxable dividends to a Nevada corporation which then repays that income as a ordinary domestic dividend subject to deduction under I.R.C. § 243 or similar state provision. Denial of an "indirect" DRD presents significant accounting and auditing challenges and will be ineffective if the indirect dividends are received by a holding company established above the operating company and the income is not repatriated to the operating company..

2. Imposition of withholding tax on dividends would be unavailing where the RIC was established in a non-tax state and the RIC lacked nexus in the taxing states.

3. A "mini" forced-combination approach presents political problems in many state legislatures. A functionally similar approach would be a statute providing that captive RICs should be "disregarded" or "collapsed" into any C corporation which contributes directly or indirectly, more than 50% of the assets to the RIC or which owns, directly or indirectly, 50% or more of the outstanding shares of the RIC. This approach works for separate entity states and should solve the sourcing issues identified above as the income will be sourced according to the operating company's factors as if the RIC did not exist. A tax credit mechanism may also be required to prevent extra-territorial taxation.

It is hoped the Income Tax Uniformity Subcommittee will give direction on how it wishes to proceed with the captive RIC project, including the possibility of proposing separate model statutes for separate filing and combined filing states.

DRAFT (With Annotations)
Multistate Tax Commission Proposed Uniform Legislation
Income & Franchise Tax Uniformity Subcommittee
Prepared March 2007

FOR DISCUSSION PURPOSES ONLY

Regulated Investment Companies (RICs)

a. The tax imposed by [state corporate income tax statute] shall be imposed upon regulated investment companies and shall be computed only upon that part of the net income of the regulated investment company which is subject to federal income tax as provided in sections 852 and 4982 of the Internal Revenue Code of 1986, as amended,[1] except as otherwise provided in this Section.

b. The term "regulated investment company" for purposes of [state corporate income tax statute] shall have the meaning ascribed to such term in Section 851 of the Internal Revenue Code of 1986, as amended.[2]

c. The dividend paid deduction otherwise allowed by federal law in computing net income of a regulated investment company that is subject to federal income tax shall be added back[3] in computing the tax imposed by this [state income tax statute] unless the regulated investment company is a Qualified Regulated Investment Company as defined in this section. [4]

d. For purposes of this section, the term "Qualified Regulated Investment Company" shall mean any regulated investment company other than a regulated investment company more than fifty percent of the voting power or value of the beneficial interests or shares of which are owned or controlled, directly or indirectly, constructively[5] or otherwise, by a single entity that is:

   1. Subject to the provisions of Subchapter C of Chapter 1 of Subtitle A of Title 26 of the United States Code, as amended, and

   2. Not exempt from federal income tax pursuant to the provisions of Section 501 of the Internal Revenue Code of 1986, as amended; and

   3. Not a regulated investment company as defined in Sec. 3 of the Investment Company Act of 1940 as amended, 15 USC 80a-3.[6]

1 This amount will be zero if the regulated investment company distributes 98% of its net income and complies with other IRC requirements to maintain its pass-through status. IRC section 852 requires

distribution of only 90% of net income to avoid a tax consequence, the same percentage as is required for REITs. However, IRC section 4982 imposes an excise tax of 4% on the amount in excess of the "required distribution" that is not distributed with respect to a tax year. For purposes of this section, the required distribution is 98% of the RIC's net income.

2 This code section defines a regulated investment company as any domestic corporation that has filed with the SEC as a management company (usually a mutual fund), or a unit investment trust (an entity of limited life that owns a fixed bundle of securities and which sells securities representing a proportional share of the underlying securities it owns), or that is a type of common trust fund. Note that the only significant requirement is that the company *register* with the SEC as a RIC. There is no requirement to actually *be* a RIC in conformity with the requirements of the Investment Company Act of 1940, as amended, which is the statute creating and governing RICs. Defining a RIC for purposes of this statute by reference to the IRC definition allows the statute to cover captive (abusive) RICs, which will likely meet the IRC's definition.

3 The deduction for dividends paid is permitted per IRC section 852(b)(2)(D). The deduction for dividends received from a RIC is not allowed per IRC section 852(b)(2)(C).

4 "Publicly traded on an established securities market" was an additional criterion with respect to the corresponding subsection in the MTC's draft model REIT legislation. It is here omitted because within the definition of a RIC is the requirement that it be publicly traded. It is difficult to imagine how an entity would not be per se a tax avoidance vehicle if it merely meets the IRC definition RIC (it registered with the SEC as a RIC) but does not meet the full requirements under the Investment Company Act of 1940 as amended, which includes the requirement to be publicly traded. The Act states, "[N]one of the following persons is an investment company within the meaning of this title: (1) Any issuer… which is not making and does not presently propose to make a public offering of its securities. Investment Co. Act of 1940, sec. 3(c)(1), 15 USC §80a-3.

5 <u>Constructive Ownership Regulations</u>
Given the relatively high 50% threshold above, states may wish to promulgate regulations with respect to attribution and constructive ownership to prevent abuses below the 50% level. For example, the statute should not permit a taxpayer to escape application of this statute merely be reducing its ownership to 49%, nor should avoidance be possible by the contrivance of two related entities, thus defeating the single entity requirement. In these and similar cases, application of the attribution and constructive ownership rules would allow the state to attribute activity and ownership of one to another for the purpose of applying this statute.

<u>IRC Section 318</u>
The best attribution rules may be IRC §318 as modified by §856(d)(5). §318 is the constructive ownership rules applicable to ownership of stock (it appears in Subchapter C -- corporate distributions and adjustments) and it is widely cited throughout the IRC as a definition of constructive ownership. §856(d)(5) applies the §318 constructive ownership rules to REITs with the following modifications, but may be equally useful with respect to RICs. Under §318, a person constructively owns a corporation when that person owns 50% or more of its value; §856(d)(5) changes it to 10% or more of its value. Similarly, under §318 a corporation constructively owns the stock of a person who owns 50% or more of the value of a corporation; §856(d)(5) changes it to 10% or more of its value. §856(d)(5) also changes the partnership constructive ownership rule such that a partner's interest does not count toward constructive ownership until it reaches 25%; presumably this rule allows for situations wherein it is difficult to determine the identities of partners with lesser interests.

IRC § 318 is referenced as the rule for constructive ownership in the following IRC sections:

- §355 (distribution of stock and securities of a controlled corporation)

- §382 (with modification -- limitation on net operating loss carry forwards and certain built-in losses following ownership change)
- §409 (with modification -- qualifications for tax credit employee stock ownership plans)
- §306 (dispositions of certain stock)
- §856 (definition of REIT)
- §871 (tax on nonresident alien individuals)
- §1060 (special allocation rules for certain asset acquisitions)
- §512 (unrelated business taxable income)
- §897 (disposition of investment in United States real property)

Other Code Sections Re: Constructive Ownership
There are other IRC sections that define constructive ownership, although they may be less useful in the present context:

- §1563(e) (for purposes of defining a consolidated group) is used by several other code sections
- §958 (with respect to controlled foreign corporations)
- §544 (for purposes of personal holding companies)
- §267(c) (limiting deductions for capital losses) is also used by §707 (transactions between partner and partnership)

MTC Model Statute on Unitary Business
Another option would be for a state to promulgate attribution and constructive ownership regulations based on the definition of ownership or control in the MTC model regulation defining a unitary business. See Reg. IV.1(b)(4), which may be found at:
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocaitonandApportionmentReg.pdf .

6 A RIC meeting this definition must be publicly traded, in addition meeting >100 owners, SEC registration, and numerous other requirements. See 15 USC 80a-3(c)(1).

Appendix B

New York RIC and REIT Combination Statute

The People of the State of New York, represented in Senate and Assembly, do enact as follows:

Section 1. Part F of chapter 60 of the laws of 2007 is REPEALED.

§ 2. Section 2 of the tax law is amended by adding new subdivisions 7, 8, 9 and 10 to read as follows:

7. "REIT" means a real estate investment trust as defined in section eight hundred fifty-six of the internal revenue code.

8. "RIC" means a regulated investment company as defined in section eight hundred fifty-one of the internal revenue code.

[Simple Definitions of Captive RIC's and REITs]:

9. "Captive REIT" means a REIT (a) that is not regularly traded on an established securities market, and (b) more than fifty percent of the voting stock of which is owned or controlled, directly or indirectly, by a single corporation that is not exempt from federal income tax and is not a REIT.

10. "Captive RIC" means a RIC (a) that is not regularly traded on an established securities market, and (b) more than fifty percent of the voting stock of which is owned or controlled, directly or indirectly, by a single corporation that is not exempt from federal income tax and is not a RIC.

[Denies Dividends Paid Deduction for Dividends Paid by a Captive to an Affiliated Member:]

However, the deduction under the internal revenue code for dividends paid by the captive RIC will not be allowed for dividends paid to any member of the affiliated group that includes the corporation that directly owns over fifty percent of the voting stock of the captive RIC. The term "affiliated group" means "affiliated group" as defined in section fifteen hundred four of the internal revenue code but without regard to the exceptions provided for in subsection (b) of section fifteen hundred four.

[Combined Reporting Required With 50% Direct Ownership:]

(6) (i) A captive REIT or a captive RIC must be included in a combined report with the corporation subject to tax under this article that directly owns or controls over fifty percent of the voting stock of the captive REIT or captive RIC.

[Rules for Combination if Ownership is Indirect: "closest controlling stockholder":]

(ii) If over fifty percent of the voting stock of a captive REIT or captive RIC is not directly owned or controlled by a corporation subject to tax under this article, the captive REIT or captive RIC must be included in a combined return or report with the corporation which is the closest controlling stockholder of the captive REIT or captive RIC subject to tax under this article, or article 32 or article 33 of this chapter. If the closest controlling stockholder of the captive REIT or captive RIC is subject to tax under this article, the captive REIT or captive RIC must be included in a combined report under this article. The closest controlling stockholder is the corporation that indirectly owns or controls over fifty percent of the voting stock of the captive REIT or captive RIC and is the fewest tiers of corporations away in the ownership structure from the captive REIT or captive RIC. The commissioner is authorized to prescribe by regulation or published guidance the criteria for determining the closest controlling stockholder.

(iii) The provisions in subparagraphs two, three and five of this paragraph must be applied before the provisions in this paragraph. If the corporation which directly owns or controls the voting stock of the captive REIT or captive RIC is described in one of those subparagraphs, the provisions in clause (ii) of this subparagraph must be applied. If, under clause (ii), the corporation which is the closest controlling stockholder of the captive REIT or captive RIC is described in one of those subparagraphs, that corporation is deemed to not be in the ownership structure of the captive REIT or captive RIC and the closest controlling stockholder will be determined without regard to that corporation.

(iv) If a captive REIT owns the stock of a qualified REIT subsidiary (as defined in paragraph two of subsection (i) of section eight hundred fifty-six of the internal revenue code), then the qualified REIT subsidiary must be included in a combined report with the captive REIT.

(v) If a captive REIT or a captive RIC is required under this subparagraph to be included in a combined report with another corporation, and that other corporation is required to be included in a combined report with another related corporation under this paragraph, then the captive REIT or the captive RIC must be included in that combined report with the other related corporation.

(vi) If a captive REIT or a captive RIC is not required under this chapter to be included in a combined report with another corporation, the captive REIT or the captive RIC is then subject to the opening provisions of this paragraph (a) and the provisions of subparagraph four of this paragraph (a). The captive REIT or the captive RIC must be included in a combined report under this article if either the substantial intercorporate transactions requirement in the opening provisions of this paragraph (a) or the inter-company transactions or agreement, understanding, arrangement or transaction requirement of subparagraph four is satisfied, notwithstanding the fact that the captive REIT or captive RIC does not meet the stock ownership requirement set forth in the opening provisions of this paragraph (a).

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(ii) In the case of a captive REIT or captive RIC required under this subdivision to included in a combined report, entire net income must be computed as required under subdivision five (in the case of a captive REIT) or subdivision seven (in the case of a captive RIC) of section two hundred nine of this article, except that the deduction under the internal revenue code for dividends paid by the captive REIT or captive RIC will not be allowed for dividends paid to any member of the affiliated group that includes the corporation that directly owns over fifty percent of the voting stock of the captive REIT or captive

RIC. The term “affiliated group” means “affiliated group” as defined in section fifteen hundred four of the internal revenue code, but without regard to the exceptions provided for in subsection (b) of section fifteen hundred four.

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[REIT and RIC Requirements for Banking Corporations:]

§ 8. Paragraph 2 of subsection (f) of section 1462 of the tax law is amended by adding a new subparagraph (v) to read as follows:

(v) A captive REIT or a captive RIC must be included in a combined return under this article if any of the provisions in this subparagraph apply.

(A) A captive REIT or a captive RIC must be included in a combined return with the banking corporation or bank holding company that directly owns or controls over fifty percent of the voting stock of the captive REIT or captive RIC if the banking corporation or bank holding company is exercising its corporate franchise or doing business in this state in a corporate or organized capacity.

(B) If over fifty percent of the voting stock of a captive REIT or captive RIC is not directly owned or controlled by a banking corporation or bank holding company exercising its corporate franchise or doing business in this state in a corporate or organized capacity, the captive REIT or captive RIC must be included in a combined return or report with the corporation which is the closest controlling stockholder of the captive REIT or captive RIC subject to tax under this article, or article 9-A or article 33 of this chapter. If the closest controlling stockholder of the captive REIT or captive RIC is a banking corporation or bank holding company exercising its corporate franchise or doing business in this state in a corporate or organized capacity, the captive REIT or captive RIC must be included in a combined return under this article. The closest controlling stockholder is the corporation that indirectly owns or controls over fifty percent of the voting stock of the captive REIT or captive RIC and is the fewest tiers of corporations away in the ownership structure from the captive REIT or captive RIC. The commissioner is authorized to prescribe by regulation or published guidance the criteria for determining the closest controlling stockholder.

(C) The provisions in paragraph four of this subsection must be applied before the provisions in this subparagraph. If the corporation which directly owns or controls the voting stock of the captive REIT or captive RIC is described in that paragraph, the provisions in clause (B) of this subparagraph must be applied. If the corporation which is the closest controlling stockholder of the captive REIT or captive RIC is described in that paragraph, that corporation is deemed to not be in the ownership structure of the captive REIT or captive RIC and the closest controlling stockholder will be determined without regard to that corporation.

(D) If a captive REIT owns the stock of a qualified REIT subsidiary (as defined in paragraph two of subsection (i) of section eight hundred fifty-six of the internal revenue code), then the qualified REIT subsidiary must be included in any combined return required to be made by the captive REIT that owns its stock.

(E) If a captive REIT or a captive RIC is required under this subparagraph to be included in a combined return with another corporation, and that other corporation is required to be included in a combined return with another corporation under other provisions of this subsection, the captive REIT or captive RIC must be included in that combined return with that other corporation.

[Exempts Banking Corporations with less than $8 Billion in Assets:]

(F) A captive REIT or captive RIC must not be included in a combined return if the banking corporation or bank holding company that directly or indirectly owns or controls over fifty percent of the voting stock of the captive REIT or captive RIC (and is the closest controlling stockholder of the captive REIT or captive RIC) is a member of an affiliated group whose members consist only of banking corporations or bank holding companies and whose members own taxable assets the combined average value of which does not exceed eight billion dollars. The term “affiliated group” means “affiliated group” as defined in section fifteen hundred four of the internal revenue code but without regard to the exceptions provided for in subsection (b) of section fifteen hundred four.

[Defines Taxable Income for Captive REITs and RIC's Owned by Banks, with Graduated Dividend Paid Deduction:]

(ii) In the case of a captive REIT required under this subsection to be included in a combined return, "entire net income" means "real estate investment trust taxable income" as defined in paragraph two of subdivision (b) of section 857 (as modified by section 858) of the internal revenue code plus the amount taxable under paragraph three of subdivision (b) of section 857 of that code, subject to the modifications required by section 1453 of this article. In the case of a captive RIC required under this subsection to be included in a combined return, "entire net income" means "investment company taxable income" as defined in paragraph two of subdivision (b) of section 852 of (as modified by section 855) of the internal revenue code plus the amount taxable under paragraph three of subdivision (b) of section 852 of that code, subject to the modifications required by section 1453 of this article. However, the deduction under the internal revenue code for dividends paid by the captive REIT or captive RIC to any member of the affiliated group that includes the corporation that directly owns over fifty percent of the voting stock of the captive REIT or captive RIC will be limited to the following percentages: (I) fifty percent for taxable years beginning on or after January 1, 2007 and before January 1, 2009; (II) twenty-five percent for taxable years beginning on or after January 1, 2009 and before January 1, 2011; and (III) zero percent for taxable years beginning or after January 1, 2011. The term "affiliated group" means "affiliated group" as defined in section fifteen hundred four of the internal revenue code but without regard to the exceptions provided for in subsection (b) of section fifteen hundred four.

(B) In the case of a captive REIT required under this subdivision to be included in a combined a return, "entire net income" means "real estate investment trust taxable income" as defined in paragraph two of subdivision (b) of section 857 (as modified by section 858) of the internal revenue code plus the amount taxable under paragraph three of subdivision (b) of section 857 of that code, subject to the modifications required by section 1503 of this article. In the case of a captive RIC required under this subdivision to be included in a combined return, "entire net income" means "investment company taxable income" as defined in paragraph two of subdivision (b)of section 852 of (as modified by section 855) of the internal revenue code plus the amount taxable under paragraph three of subdivision (b) of section 852 of that code, subject to the modifications required by section 1503 of this article. However, the deduction under the internal revenue code for dividends paid by the captive REIT or captive RIC will not be allowed for dividends paid to any member of the affiliated group that includes the corporation that directly owns over fifty percent of the voting stock of the captive REIT or captive RIC. The term "affiliated group" means "affiliated group" as defined in section fifteen hundred four of the internal revenue code but without regard to the exceptions provided for in subsection (b) of section fifteen hundred four.

[Requires Captive RICs and REITs to be Included on Combined Return of Insurance Companies]

(4)(A) A captive REIT or a captive RIC must be included in a combined return with the corporation that directly owns or controls over fifty percent of the voting stock of the captive REIT or captive RIC if the corporation is a life insurance corporation subject to tax under this article.

[Instructions if REIT/RIC ownership is Indirect—Closest Controlling Corporation]

(B) If over fifty percent of the voting stock of a captive REIT or captive RIC is not directly owned or controlled by a corporation subject to tax under this article, the captive REIT or captive RIC must be included in a combined return or report with the corporation which is the closest controlling stockholder of the captive REIT or captive RIC subject to tax under this article, or article 9-A or article 33 of this chapter. If the closest controlling stockholder of the captive REIT or captive RIC is a life insurance corporation subject to tax under this article, the captive REIT or captive RIC must be included in a combined report under this article. The closest controlling stockholder is the corporation that indirectly owns or controls over fifty percent of the voting stock of the captive REIT or captive RIC and is the fewest tiers of corporations away in the ownership structure from the captive REIT or captive RIC. The commissioner is authorized to prescribe by regulation or published guidance the criteria for determining the closest controlling stockholder.

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(C) If a captive REIT owns the stock of a qualified REIT subsidiary (as defined in paragraph two of subsection (i) of section eight hundred fifty-six of the internal revenue code), then the qualified REIT subsidiary must be included in any combined report required to be made by the captive REIT that owns the stock of the qualified REIT subsidiary.

(D) If a captive REIT or a captive RIC is required under this paragraph to be included in a combined report with another corporation, and that other corporation is required to be included in a combined report with another related corporation under this subdivision, then the captive REIT or the captive RIC must be included in that combined report with the other related corporation.