MULTISTATE TAX COMMISSION

Report of the Hearing Officer Regarding Proposed
Model Statute for Taxation of
Captive Real Estate Investment Trusts
October 2007

I. Introduction

On August 2, 2007, the Multistate Tax Commission (MTC) Executive Committee approved for public hearing an MTC proposed model statute for the taxation of captive Real Estate Investment Trusts (REITs). The appointed hearing officer held a public hearing in Washington, D.C. on October 26, 2007. Two sets of written comments were received prior to the hearing and oral comments were offered by attorneys representing the revenue departments of the states of Georgia and Wisconsin. The hearing officer's report summarizes the proposal's procedural background, key substantive features and public comments. The report recommends adoption of the proposal with some modifications.

II. Procedural Summary

A. Development of the Proposal:

In 2004 the Executive Committee of the Multistate Tax Commission authorized the formation of a special taskforce to study the effects of tax sheltering and to recommend statutory changes to combat sheltering. The increased use of pass-through entities as a means of avoiding tax liabilities became one focus of that group. The income tax uniformity subcommittee of the Uniformity Committee voted in March of 2006 to study the problems associated with the use of Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs) to shelter income from taxation and to develop a model statute to combat such practices. A drafting group was formed[1] and a policy checklist was developed. At the July 2006 meeting, the Subcommittee voted to limit the statutory drafting efforts to the problems arising from the use of REITs and RICs established with the intent of avoiding state income taxation, rather than addressing some states' broader concerns with the use of pass-through entities generally and their impact

[1] The drafting group consisted of: Joe Garrett, Alabama Department of Revenue; Carl Joseph, Franchise Tax Board; Reva Tisdale, Idaho Department of Revenue; Leonore Heavey, Louisiana Department of Revenue; Brenda Gilmer, Montana Department of Revenue; Lennie Collins, North Carolina Department of Revenue; Janielle Lipscomb, Oregon Department of Revenue; Kim Ferrell, Utah Department of Revenue; and Tom Shimkin, Counsel with the Multistate Tax Commission.

on source-based taxation. In November of 2006, the Subcommittee voted unanimously to bifurcate the drafting efforts for RICs and REITs.

Two draft model statutes were presented to the Income Tax Uniformity Subcommittee in San Diego, California in March of 2007. The Subcommittee agreed with the direction taken in those model statutes for RICs and REITs and authorized preparation of a final proposal for the REIT model statute. As a result of further deliberation and development, a draft of a proposed REIT model statute was presented to the Income Tax Uniformity Subcommittee meeting in Minneapolis, Minnesota in July of 2007. As a result of suggestions by some members of the REIT investment community, the Subcommittee voted to amend the draft model statute to broaden the definition of "qualifying" REITs (entities which, although not publicly traded, were still not deemed captive REITs subject to tax) to include foreign investment vehicles which operate similarly to Listed Australian Property Trusts. The proposed draft model statute as amended was approved by the Subcommittee and later submitted to the full Uniformity Committee after further additional minor amendments, where it also received approval.

The Executive Committee considered the proposed draft on August 2, 2007. A motion was made before the executive committee to change the title of the proposal to include the word "captive", to add a new Section A, and to amend section E to eliminate a reference to federal conformity for taxation of REITs other than captive REITs. The significance of these amendments is discussed below. The motion to amend the proposed model statute was carried and the model statute as amended was approved for public hearing.

B. Public Hearing.

After more than 30 days notice to the public and interested parties, a Public Hearing was held on October 26, 2007 in Washington, D.C. Two sets of written comments were received prior to the hearing and oral comments were offered by attorneys representing the revenue departments of the states of Georgia and Wisconsin. The written comments are attached as Exhibits:

Exhibit A: *Comments on Multistate Tax Commission's Proposed Model Statute for Taxation of Captive Real Estate Investment Trusts* from the National Association of Real Estate Investment Trusts (NAREIT).

Exhibit B: *Re: Proposed Model Uniform Statute for Taxation of Captive REITs (Captive REIT Proposal)* from Property Council of Australia

III. Summary of Substantive Provisions

A. Purpose of Proposed Model Statute:

This model statute is intended to prevent the misuse of the Real Estate Investment Trust (REIT) structure as a means to reduce state corporate income and franchise tax liabilities in a manner contrary to the intent and spirit of state tax laws.

Congress created REITs in 1960 to encourage pooled investments in income-producing real estate, such as apartments, hotels, shopping centers, and offices, allowing a wide range of investors access to professional management without entity-level taxation. The statutory system was patterned after special tax treatment afforded to Regulated Investment Companies (RICs) in 1940 which spurred the growth of the mutual fund industry. To ensure that REITs would be used as a vehicle to encourage investment in the real estate market, Congress imposed several restrictions on their structure, including a requirement that REIT ownership must be widely held (shared by at least 100 persons). IRC § 856(a)(5). REITs share some of the tax attributes of simple trusts, most significantly the effective pass-through of income tax liability to the beneficial owners. REITs are not technically pass-through entities. Any income not distributed by the REIT is subject to tax at the REIT entity level. However, Congress also required that a REIT annually distribute at least 90% of its earnings as a dividend. The elimination of entity-level taxation is achieved through the allowance of a dividends-paid deduction under Internal Revenue Code (IRC) § 857. Corporations receiving REIT dividends are not permitted to claim a deduction for those dividends for federal tax purposes, in contrast to treatment afforded to ordinary domestic dividends under IRC § 243.

Beginning in the 1990's, some corporations saw an opportunity to reduce their state income tax liability by using the REIT structure to isolate operating income beyond the reach of taxing authorities. Closely-controlled REITs have been established by many corporate taxpayers, especially those in the retail and financial industries. Income-producing assets like retail stores and pooled mortgage interests are transferred into the REITs, creating the opportunity to claim a deduction for lease expense and interest expenses to be paid to these REITs, thus reducing the operating companies' reported net income subject to tax. While the great bulk of the REIT ownership is held by a single corporate subsidiary, very small amounts of beneficial ownership are also transferred to corporate officers or similar "insiders" in order to meet the 100 shareholder requirement of IRC § 852(a)(5). Neither the subsidiary nor the corporate insiders can be considered "investors" in real estate in any reasonable sense of the word.

The rental or interest income generated by the REIT assets is then paid as a dividend to a subsidiary or affiliate of the taxpayer. These entities are usually established in Nevada or in some other state which does not impose an income tax, and frequently, the dividend is paid to a "captive" insurance company or "offshore" ("80/20") subsidiary that may not be subject to combination in states which impose unitary combined reporting requirements.

The income from the REIT is then ultimately returned to the corporate parent in the form of an ordinary deductible domestic dividend or loan, perhaps after passing through other subsidiaries or affiliates. Thus, the income from these controlled ("captive") REITs is effectively insulated from state taxation. The operating or parent corporation, meanwhile, now enjoys reduced income tax liability because it is able to claim a deduction for rental expense or interest expense paid to the captive REIT. The mechanics of the captive REIT scheme and income flows are described in detail in *Bridges v. Autozone, Inc., 900 So. 2d 784 (2005)*.[2]

The captive REIT structure serves to reduce taxes more directly in some states which allowed a deduction for all domestic dividends received and did not distinguish dividends received from REITs and RICs (which are fully subject to federal tax because the dividend-paying entity was allowed a dividends paid deduction.)[3] Because this proposed model statute is limited to the taxation of captive REITs, it should not be seen as a substitute for legislation which may be required to clarify state tax treatment of dividends from pass-through entities generally.

B. Operation of the Model Statute:

The application of the proposed model statute to the problem of captive REITs can be easily summarized. First, the statute identifies its purpose being limited to addressing a specific practice involving use of the captive REIT structure to improperly avoid tax liability. Larger questions of whether the states should continue to adhere to federal practices with respect to shareholder residency-based taxation of income from pass-through entities is recognized as a separate matter for states to consider. Second, the model statute defines a "captive" real estate investment trust as a REIT which is not traded on an established securities market and which is majority owned, directly or indirectly, by a single entity subject to taxation as a "C" corporation. Third, the statute identifies several exceptions to the captive REIT definition for "qualifying" REITs which are not considered as vehicles intended to minimize state taxation. Fourth, the federal dividends-paid deduction for captive REITs is added-back for state purposes. Finally, the model statute describes rules for determining indirect or "constructive" ownership by reference to two federal tax statutes. Some broader considerations about the model statute are discussed in subsection 1-4, below, with a section-by-section summary following in subsection 5:

1. <u>Denial of Dividends-Paid Deduction Permits Entity-Level Taxation.</u>

The proposed model statute combats the tax effects of captive REITs by adding back the federal dividends-paid deduction (DPD) which is otherwise available to the REIT under IRC § 857(b)(2). This has the effect of imposing state income taxes on the bulk of the REIT income at the entity level rather than at the shareholder level, reducing the possibility that income tax can be avoided by establishing a holding company in a tax-

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[2] More recently, an article in the Wall Street Journal regarding the creation and operation of a captive REIT allegedly established by that taxpayer has generated considerable interest in state legislatures. Tax experts quoted in the article opined that Wal-Mart may have saved up to $350 million in state taxes in just four years. Wall Street Journal, 2/10/07, page 1.

[3] *See, e.g., Bank Boston Corporation v. Commissioner, 68 Mass. App. 156, 861 N.E. 2 450* (2007), holding that the Massachusetts legislature intended to tax such dividends for periods even prior to the effective date of clarifying legislation..

free jurisdiction or business structure to receive the taxable dividends. The drafting group and the income tax uniformity subcommittee chose to eliminate the dividends-paid deduction as a relatively simple and efficacious approach to negate the tax benefits of captive REITs. This approach was also chosen because it is the method which has already been adopted by several state legislatures in recent years and would thus foster uniformity among the states.[4] Finally, the methodology was chosen as having the potential for the least disruption of the legitimate investment-oriented REIT industry.

2. Nexus:

Denying the deduction for dividends paid as a method of eliminating the improper tax effects of captive REITs necessarily assumes that the taxing state will have jurisdiction to tax ("nexus") over the REIT. For states which impose income taxes on a separate entity reporting basis, nexus will be limited to captive REITs that own real property in the state. Nexus disputes may also arguably arise where a captive REIT owns indirect real estate interests, such as mortgage pools. For combined filing states, jurisdiction to tax should not be as much of an issue, since a captive REIT will almost certainly be treated as a member of the unitary combined group.[5]

Entity-level taxation as embodied in this proposed model statute will not be effective for separate-entity states where the REIT chooses to eliminate its real property holdings in that state. For instance, if a retailer chooses to transfer ownership of its stores located only in combined filing states to a captive REIT, the retailer would still be entitled to claim a deduction for rent paid to its captive REIT in those states, reducing its pre-apportioned net income as reported to the separate-entity state. The separate entity state would receive no benefit from the imposition of tax on the captive REIT, however, since the REIT has no nexus or apportionment factors in that state.

3. Potential for "Double-Taxation" of Income.

The proposed model statute imposes taxation at the entity level but does not include any mechanism to eliminate the potential for taxing that income again when it is received by a holding company or similar entity. Under IRC § 857(b)(2), corporations are not allowed a dividends-received deduction for dividends paid from a REIT. States which conform to federal dividend treatment and that adopt this proposed model statute arguably run the risk of claims that they are taxing "the same income" twice. States may therefore wish to consider adoption of a dividends-received deduction or tax credit to the extent comparable taxes were paid on the dividends at the entity level.[6]

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[4] Those states include Indiana, Illinois, Kentucky, Louisiana, Mississippi, Maryland, North Carolina, Rhode Island and New York.

[5] New York has gone further and specified that a captive REIT or RIC is required to file returns on a unitary combined basis.

[6] An example of a mechanism for providing a credit for taxes paid can be found in the MTC's Model Statute Requiring Add-Back of Certain Intangible and Interest Expenses, www.mtc.gov, *Adopted Proposals*. That provision could be modified for captive REIT dividends as follows:

As a practical matter, such a provision should be unnecessary because the definition of captive REIT is so narrowly drawn that it should only capture REITs intended to achieve state tax advantages. Those REITs have been designed explicitly so that the recipient is not subject to any state's tax on its dividends. Any concerns over "double-taxation" of income appear for the moment to be more academic than actual. In addition, no true double taxation would occur, even if a state did impose tax on the dividend recipient, because a dividend received by a taxpayer is a separate taxable event from the earning of net income by the REIT paying that dividend. Significantly, none of the captive REIT statutes passed by the states to date provides for any kind of mechanism for elimination of tax on the dividend recipient.

4. <u>Distinctions Between "Captive" and "Qualifying" REITs.</u>

As set forth above, the proposed model statute was written to have the least possible impact on current state taxation policies applicable to the *bona-fide* REIT industry. Thus, the definition of captive REITs and the many exceptions for closely-held REITs which nonetheless would not be subject to tax (so-called "qualifying REITs") were written with that policy consideration in mind. This approach raises two concerns. The first concern is that a taxpayer may be able to circumvent the intent of the statute by reorganizing its captive REIT to meet one of the exceptions to taxation, through, perhaps, multiple tiers of ownership involving non-taxable entities. The second concern is that a closely-held REIT which was not organized for the purposes of minimizing state taxation may find itself subjected to taxation because the list of qualifying REITs was incomplete and is a static compilation as of the time the statute is adopted. One response to these problems would be to provide discretionary authority to tax commissioners to expand or limit the application of the statute in particular circumstances. The drafters of the proposed model statute believed such discretionary authority would create administrative problems and might hamper the overall effectiveness of the statute. The model statute is thus silent as to matters of discretionary or equitable relief, leaving those questions to determination under generally applicable state tax laws and procedures. The hearing officer notes that

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(c) If the [dividend recipient] was subject to tax in this state or another state or possession of the United States or a foreign nation or some combination thereof on a tax base that included the [dividend] paid, accrued or incurred by the taxpayer, the taxpayer shall receive a credit against tax due in this state in an amount equal to the higher of the tax paid by the [dividend recipient] with respect to the portion of its income representing the [dividend] paid, accrued or incurred by the taxpayer, or the tax that would have been paid by the [dividend recipient] with respect to that portion of its income if (1) that portion of its income had not been offset by expenses or losses or (2) the tax liability had not been offset by a credit or credits. The credit so determined shall be multiplied by the apportionment factor of the taxpayer in this state. However, in no case shall the credit exceed the taxpayer's liability in this state attributable to the net income taxed as a result of the [denial of the dividends-paid deduction] required by [Section E] of this statute.

none of the captive REIT statutes passed to date provides for any sort of discretionary coverage or relief.

5. <u>Discussion and Analysis of Intent of Proposed Model Statute, by Section:</u>

A. Section A provides that the purpose of the statute is to address the problems created by the use of captive REITs. The section is intended to make clear that model statute is not intended as an endorsement, or a rejection, of residency-based taxation for income earned by pass-through entities or other non-taxed entities outside the context of captive or abusive REITs.

B. Section B defines a Real Estate Investment Trusts by reference to federal statutes.

C. Section C defines a captive REIT. It provides that the statute is intended to apply to a REIT which is owned or controlled, directly, indirectly, or constructively, by an entity subject to federal income taxation. Section C(2) is a recognition that some REITs are currently owned by pension funds and other 501(a) organizations which are not subject to federal tax.

D. Section D is a list of entities which may be majority owners of a REIT but whose ownership would not trigger "captive" REIT status. D(1) provides for an exception of REITs owned by other REITs, except for captive REITs. D(2) describes REITs owned by REIT subsidiaries, except for captive REIT subsidiaries. Because of the indirect and constructive ownership rules of C, these provisions should not allow a captive REIT to shield its income through multiple tiers of ownership. D(3) includes listed Australian Property Trusts as entities which may own a controlling interest in a REIT without triggering captive REIT status. Australian Property trusts are widely held and it is believed they could not be used as a mechanism to defeat the intent of the statute to prevent a corporation from creating an artificial deduction for real estate expenses. As set forth in Exhibit B attached hereto, Australian trusts provide a widely-used vehicle for encouraging investment in U.S. real estate without sourced-based taxation. It should be noted that the IRC does impose a 15% withholding tax on distributions to foreign trusts, something no state currently attempts. D(4) is intended to provide a catch-all exception for ownership of U.S. REITs by trusts organized outside the United States which are similar in operation to Listed Australian Property Trusts. Currently several other countries, including Canada, are considering amending their tax laws to recognize pass-through treatment for REIT-like structures which may in turn invest in U.S. REITs. D(4) was drafted to mimic current rules for Listed Australian Trusts and to make it difficult for a U.S. corporation to organize such a foreign REIT for the purpose of avoiding state income taxation.

E. Section E of the proposed model statute provides for the add-back of dividends which are otherwise deductible for captive real estate investment trusts.

F. Section F of the proposed model statute allows an exception to captive REIT treatment for so-called "incubator trusts", which are closely held trusts established for the purposes of demonstrating feasibility of the investment plan prior to the shares being offered to a wider audience. The I.R.C. provides a one-year window for such trusts wherein they are afforded REIT treatment despite being closely held. At the public hearing of this matter, it was suggested that "intended to be regularly traded" exception could provide a loophole for captive REITs based on subjective claims of intent. The hearing officer agrees and proposes an amendment as discussed below to eliminate this potential problem.

G. Section G adopts constructive ownership rules as defined by the IRC.

IV. Summary of Written and Oral Comments and Recommendations.

1. The National Association of Real Estate Trusts (NAREIT) submitted written comments (Exhibit A) generally supporting the proposed model statute but suggesting the best approach would be to continue to conform to federal treatment of all REITs. The comments from NAREIT include a detailed description of many closely-held REITs which have legitimate (non-state-tax motivated) business purposes. NAREIT mentions the possibility of double-taxation if states were to deny the DPD while continuing to follow the federal treatment of REIT dividends. For the reasons previously-discussed, the hearing officer believes that the current proposal's limited impact to captive REITs effectively precludes a realistic possibility of double taxation. The hearing officer cannot agree with the suggestion that the states should not act to address the captive REIT problem through statute, and believes that this statute is the least burdensome method to protect state interests.

2. The Property Council of Australia ("the Council") submitted written comments generally supportive of the proposal but suggesting two substantive changes. (Exhibit B). First, the Council suggests an amendment to D(4) of the proposed statute, a subsection which was intended as a catch-all provision to allow qualified ownership treatment for entities like Listed Australian Property Trusts (LAPTs) but which are not themselves LAPTs. The Council suggests that some Australian Trusts functional like LAPTs but are not themselves listed, and thus need to rely on D(4). Subsection D(4)(b) provides that an entity must receive a dividends-paid deduction comparable to Section 561 of the IRC. The Council points out that Australian Property Trusts are not subject to tax on distributed earnings, but the tax treatment is not in the nature of a DPD. In addition, the Council notes that Australian Property Trusts are not required to distribute their earnings, although failure to do so would result in taxation at the highest marginal rates.

The hearing officer recommends an amendment to Section D(4)(b) and (4)(c) to meet the Council's concerns. First, the hearing officer recommends striking the current language in the subsection and to provide instead:

"(b) the entity is not subject to tax on amounts distributed to its beneficial owners, or is exempt from entity level taxation;"

The hearing officer recommends an amendment to Subsection d(4)(c) to read:

"(c) the entity [is required to distribute] <u>distributes</u> at least 85% of its taxable income (as computed in the jurisdiction in which it is organized) to the holders of its shares or certificates of beneficial interest on an annual basis;"

The Council also urges an amendment to accommodate widely held "Wholesale Property Trusts" which apparently operate in a manner similar to LAPTs but are not themselves listed on a public exchange. The Council urges an amendment to Subsection D(4)(d) to the statute to provide that "widely held" would include ownership by seven different categories of closely held entities, including an entity whose shares are regularly traded on an established securities market. The hearing officer has a concern that such an amendment may be inconsistent with the intent to the statute. Almost all large corporations trade their shares on established securities markets. Although it may be far-fetched, it seems remotely possible that a corporation subject to state taxation could hold ownership in a captive REIT through a Wholesale Property Trust and still obtain a state tax benefit. It is more likely that such an arrangement would result in additional federal withholding tax. The hearing officer has asked the Council to expand upon its statement and to provide alternative language to accomplish its goals. The hearing officer cannot recommend this change at the present time.

3. An attorney from the Wisconsin Department of Revenue expressed concern that the "incubator trust" provisions of Section F could be abused by captive REITs. In theory, a corporation could transfer its assets on an annual basis from one "incubator trust" to another, always with the purported intent of someday becoming widely held. The hearing officer believes that this scenario, while seemingly unlikely, cannot be ruled out entirely, and so recommends addition of language which would retroactively impose liability on an incubator REIT which did not become regularly traded and which meets the other conditions of being a captive REIT. That language was included in earlier drafts of the proposed model statute:

> A real estate investment trust that does not become publicly traded on an established securities market within one year of the date on which it first becomes a real estate investment trust shall be deemed not to have been publicly traded on an established securities market, retroactive to the date it first became a real estate investment trust, and shall file an amended return reflecting such retroactive designation for any tax year or part year occurring during its initial year of status as a real estate investment trust. For purposes of this section, a real estate investment trust becomes a real estate investment trust on the first day that it has both met the requirements of IRC §856 and has elected to be treated as a real estate investment trust pursuant to IRC § 856(c)(1).

IV. Additional Recommendation for Separate Filing States.

Because the model statute as currently proposed may not be effective with respect to captive REITs which are not subject to a separate entity's state's taxing jurisdiction, the hearing officer recommends that states consider amending their current add-back statutes to explicitly include the add-back of rents and interest expenses paid to a captive REIT.

Respectfully submitted,

Bruce J. Fort
Hearing Officer

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

October 24, 2007

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Re: Comments on Multistate Tax Commission's Proposed Model Statute for Taxation of Captive Real Estate Investment Trusts

Dear Bruce:

The National Association of Real Estate Investment Trusts (NAREIT)® thanks you for the opportunity to submit comments on the Multistate Tax Commission's (MTC) draft Proposed Model Statute for Taxation of Captive Real Estate Investment Trusts, which is posted on www.mtc.gov (Final Draft). Furthermore, NAREIT would like to thank you for the opportunity to have participated over the last year in the MTC's process of preparing this draft.

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

The Final Draft first provides that it is meant to address captive REITs only and should not be interpreted as precluding the right of a state to tax the income earned by any type of REIT as source income. The Final Draft then provides that a dividends paid deduction (DPD) should be added back for state corporate income tax purposes by a REIT that is a captive REIT.

A "captive REIT" is defined as a REIT, that is not: a) a publicly traded REIT and of which b) more than 50% of the voting power or value of beneficial interests or shares are directly or indirectly owned or controlled by a single taxable entity that is treated as an association taxable as a corporation under the Internal Revenue

Code of 1986, as amended (the Code). The Final Draft then excludes from the definition of entities treated as associations taxable as corporations: REITs, qualified REIT subsidiaries (QRSs); “listed Australian property trusts,” as specifically defined (LAPTs) (Australia’s version of the U.S. REIT) and/or trusts 75% or more held by an LAPT; and certain non-listed and listed foreign REIT-like entities.

NAREIT supports the Final Draft because it specifically addresses the DPD of “captive REITs” without affecting the DPD of widely held and/or publicly traded REITs. With that said, NAREIT continues to believe that the most appropriate model for state taxation of REITs and their shareholders is conformity with federal principles (as is the case for publicly traded REITs in all states but one that have an income-based tax system). Under this model, a state permits a (non-captive) REIT a DPD while taxing its residents on REIT dividends regardless of where the income giving rise to those dividends was generated.

Set forth below is background concerning the REIT structure and more details concerning our comments.

DISCUSSION

I. <u>Background</u>

A. REITs Are Not “Tax Shelters,” But Were Designed to Benefit the “Small Investor.”

Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through professionally managed companies. REITs 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. 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), federal law grants REITs (and mutual funds) a DPD. In 2006, publicly traded REITs distributed more than $15 billion to their shareholders.

B. REITs Benefit Investors and the Economy.

Congress' vision has been realized: as of September 2007, more than 150 publicly traded REITs had a total equity market capitalization of more than $370 billion. Throughout the U.S., real estate owned by REITs generates millions of dollars in property taxes on top of the individual income taxes currently generated by REIT dividends paid to state residents. Investors have benefited from owning REITs: the 15-year compound annual return for the period ending Aug. 31, 2007 of the S&P 500 stock index was 10.92%, **while that of REITs was 13.42%**.

The economy benefits from REITs as well – because REITs cannot pass through losses to investors (unlike partnerships), their focus must be on creating value for shareholders. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public REITs are less than 50%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Simply put, REITs are the most practical method for investors to add commercial real estate in their investment portfolios to obtain the asset diversification recommended by most financial advisors.

C. Most States Tax REIT Income Only Once at the Shareholder Level.

All but one state with an income-based tax system allow the DPD for public REITs. As a result of the DPD, most, if not all, of a REIT's income is taxed at one level – the shareholder level. Only Mississippi limits its DPD to "publicly traded" REITs, a term which is not defined. In 2007, Maryland enacted legislation (identical bills, H.B. 1257 and S. 945) that permits the DPD to reduce Maryland taxable income only for a REIT that is either: (i) publicly traded; or (ii) not more than 50% held by a taxable corporation that is not a REIT or an LAPT. Also in 2007, Kentucky (H.B. 258) and Indiana (S. 500) adopted statutes that are conceptually similar to the Maryland statute (although the triggering threshold in Kentucky is lower than in the other states). Louisiana adopted a similar statute in 2005, H.B. 888. Other states adopting similar statutes this year include Illinois (S.B. 1544) and Rhode Island (H.B. 5300).

The above-mentioned statutes prevent or would prevent a REIT from being used primarily to escape state income taxes, while not disturbing the economic activities of widely held REITs.

D. Non-Publicly Traded REITs Are Used For Many Legitimate Transactions.

Although there has been a great deal of press recently concerning the use of private REITs as a "state tax shelter," the following legitimate structures are representative of REITs that are not publicly traded:

- <u>SEC-registered, non-exchange traded REITs</u>. There are a number of REITs that are required to register with the SEC due to the size of their shareholder and asset base, but are not traded on any exchange. Recently, several of these have become publicly traded.

- "Incubator" REITs that plan an eventual public offering. Several publicly-traded REITs began as privately-held REITs in order to establish a track record for management. Thereafter, they engaged in a public stock offering. Limiting the DPD to publicly traded REITs would negatively affect the business plans of these companies.

- Widely held, non-publicly traded REITs. There are also a number of REITs with sizeable property portfolios and shareholder bases that are privately held, often by tax-exempt institutions.

- Non-public subsidiaries of publicly traded REITs and LAPTs. In certain cases, a publicly traded REIT that acquires another publicly traded or widely held REIT will keep the acquired company as a private REIT subsidiary for goodwill purposes or to avoid the need to obtain lender consents. Similarly, LAPTs, Australia's version of the U.S. REIT, often own U.S. REIT shares directly to facilitate compliance with the U.S.-Australian Tax Treaty by their small unitholders. Additionally, tax-exempt institutions and/or LAPTs may invest, along with one or more publicly traded REITs, in a joint venture entity formed as a privately held REIT.

II. Comments

NAREIT appreciates the careful thought undertaken by the MTC in preparing the Final Draft and appreciates the opportunity over the past year to provide comments to the MTC in connection with its preparation of the Final Draft.

We believe that the most appropriate method of taxation for REITs and their shareholders in states with income tax regimes is to conform to the federal model of taxation. As noted above, virtually every state with an income-based tax structure allows publicly traded REITs the DPD. Additionally, these states then tax all REIT dividend income received by resident shareholders, regardless of where the REIT's real estate is located.

For example, State A imposes an income tax on all of the REIT dividends earned by a State A resident shareholder of a REIT with only State B properties, while State B imposes its income tax on all of the REIT dividends earned by a State B resident of a REIT with only State A properties. In that example, neither state imposes income taxes on the REIT based on the location of in-state property. If State A were to seek to impose an additional REIT-level tax on a REIT with State A properties, that would result in double taxation of that REIT's income and inappropriate revenues to State A, making State A's tax policy out of sync with the rest of the nation.

With that said, we recognize a state's interest in adopting legislation that would limit any inappropriate use of REITs, including "captive REIT" structures that have been publicized recently, by denying the DPD in certain cases involving certain non public REITs. However, any such legislation should be narrowly tailored to prevent application to legitimate uses of business transactions such as those described in the prior section. We support the Final Draft. To the extent that the MTC may wish to explore other types of limitations on the uses of captive REITs, including in those states that follow the "separate entity" method of reporting, again, we would welcome the opportunity to work with you further.

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Thank you again for the opportunity to submit these comments. Please contact me at (202) 739-9446, or my colleague Tony Edwards, at (202) 739-9408 if you would like to discuss these comments in more detail. I plan to attend the Nov. 6, 2007 MTC Uniformity Committee meeting via teleconference. I also plan to attend in person the Nov. 8, 2007 MTC Executive Committee meeting. I will be available to discuss these comments in more detail there as well.

Sincerely,

Dara F. Bernstein

Dara F. Bernstein
REIT Counsel

26 October 2007

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bfort@MTC.gov

Dear Mr Fort

Re: Proposed Model Uniform Statute for Taxation of Captive REITs (Captive REIT Proposal)

Introduction

Thank you for the opportunity to comment on the Captive REIT proposal.

By way of background, the Property Council of Australia is the peak body representing the interests of owners and investors in Australia's $320bn property investment sector. Our members are all of the leading institutional investors covering the entire real estate investment universe.

Importantly, our members include the major REITs that invest domestically and overseas including the US. The Australian REIT market is the second largest globally and represents:

- 12% of the world's listed real estate assets;
- 10% of Australia's Gross Domestic Product (GDP); and
- 12% of FTSE EPRA/NAREIT Global Real Estate Index.

More than 40% ($60bn) of Australian REIT funds is invested in overseas assets including the US.

Similarly, approximately 1/3rd or $40bn of money invested in Australian REITS comes from overseas. US investors hold on average 15% of the register of Australia's major REITs.

The Issue

The Property Council supports the MTC's efforts to ensure the integrity of its tax laws, however we submit that such measures must be careful to avoid unfairly and adversely targeting legitimate enterprises.

Our members are concerned that the Captive REIT Proposal definition (and exemptions), do not adequately cover Australian REITs.

As a starting point it is important to note that Australian Property Trusts are "tax transparent and are deemed publicly traded entities in the US. A US Captive REIT held by an Australian Property Trust is not an arrangement that gives rise to potential tax abuse. It is simply the most efficient structure for Australian REITs to invest in US real estate

While the substance of the MTC's draft language is appropriate, it inadvertently does not properly categorise "Australian Property Trusts" as "qualified entities" because of non-material technicalities regarding distribution and the DPD. In addition, it may apply to many widely held but unlisted property trusts.

The proposal therefore could potentially deny the dividend paid deduction (DPD) for US REITs owned by Australian Property Trusts which are in themselves widely held.

This will impact Australian Property Trusts though a substantial increase in their state income tax liabilities, and significantly undermine the value of these vehicles.

The net effect will be to strip value from these investments.

In our view, the proposal can solve this problem by:

1) adding another provision at d(4) which deems LAPTs to fulfil the conditions for distribution and direct receipt of the dividend deduction; and

2) amending d(4)(d) to include widely held trusts.

Qualified Entities

The Captive REIT Proposal provides a general exception for Listed Australian Property Trusts (LAPTs) at d(3), however, it does not cater for all variations of Australian Property Trusts that may be unfairly caught under the proposal.

Many Australian Property Trusts are therefore required to seek exemption under d(4) as a Qualified Foreign Entity. However, many Australian Property Trusts that are intended to be brought within the ambit of the exception, cannot use the exception as they do not technically qualify under:

1) **d(4)(b)** ***"the entity receives a comparable dividend paid deduction"*** – technically, Australian Property Trust do not receive a dividend paid deduction as they are not taxed on "dividends" but distribute all income as a tax flow through vehicle. They cannot technically meet this criteria but are within the implied spirit as no tax is levied on the distributions in the hands of the Australian Property Trust.

2) **d(4)(c)** ***"the entity is required to distribute 85% of its taxable income"*** – in a strict sense no Australian Property Trust is "required" to distribute. They distribute 100% in all cases because they would

otherwise be subject to the highest marginal tax rate and the trust would be economically unviable.

These are effectively non-material technicalities.

We suggest that another provision is added to d(4) that effectively deems our trusts to fulfil the conditions:
"A unit trust created and resident in Australia under its income tax law shall be deemed to satisfy subparagraphs b and c of paragraph 4".

Widely Held Wholesale Trusts

Within the Australian tax system, Wholesale Property Trusts (direct investment vehicles which are not listed), have the same flowthrough tax status as LAPTs providing (relevantly), the units in the Trust are either:

1) owned by 50 or more unitholders; or
2) are offered to the public.

In these circumstances, the Wholesale Property Trust might technically fail d(4)(d) in the proposal, due to the smaller number of unitholders, yet still adhere to the spirit of the criteria, ensuring the excluded entity is widely held.

We consider that the proposal should amend d(4)(d) to focus on widely held as the necessary criteria.

Paragraph d(4)(d) should insert after *"individual"* the following words *"other than an entity that is directly or indirectly widely held".*

A definition of widely held needs to be added along the lines of:

"The following entities shall be treated as widely held:

1. an entity the shares or beneficial interests of which are regularly traded on an established securities market;

2. an insurance company, a life insurance company or a bank;

3. an entity with more than 50 members none of whom own more than 10% of the voting power or value of the entity;

4. a pension or similar fund, membership of which is publicly available;

5. a State, subdivision or local authority thereof and any agency or instrumentality of such State;

6. a charity or not-for-profit body the income of which is exempt under the law of the State where it is created and resident; and

7. any other type of domestic or foreign entity specified in regulations."

The Property Council is confident that the majority of our concerns can be addressed in the proposal to enable us to give you our support.

We would be pleased to expand on any point we have raised. Please do not hesitate to contact me on (02) 9033 1900.

Yours sincerely,

Trevor Cooke
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Property Council of Australia