MULTISTATE TAX COMMISSION

MEMORANDUM

TO: Wood Miller, Chair
MTC Income & Franchise Tax Uniformity Subcommittee

FROM: Bruce Fort, Counsel, Multistate Tax Commission

DATE: 3/7/08

RE: **Status Report on Efforts to Develop Uniform Model Statute for Taxation of "Abusive" Regulated Investment Companies**

Since early 2006, the Income and Franchise Tax Uniformity Subcommittee has been working on model legislation addressed to the use of closely-held Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) to avoid state corporate income taxation. In November of 2006 the committee voted to bifurcate the drafting process for the two types of entities. Since that time, a model statute addressed to the taxation of captive REITs has been proposed and is currently the subject of a Bylaw 7 survey to the states to gauge whether the proposal, if adopted, would likely be considered by the states.

The closely-held RICs project has proceeded more slowly for several reasons. First and foremost, the use of captive RICs appears to be limited to financial institutions which generate loans and other securities. Second, some evidence suggests that RICs have fallen out of favor as a tax planning device because of, *inter alia*, the reported efforts by the Securities and Exchange Commission to police the registrations of such companies to ensure these entities meet the intent of the Investment Company Act of 1940. Finally, the use of closely-held RICs presents additional challenges to states, especially separate entity states, which are not present with respect to the taxation of captive REITs.

Background of the Problem: The Dividends-Paid Deduction Creates Unintended Tax Gaps for States with Non-Conforming Dividend Treatment and Certain Combination States.

Regulated Investment Companies are defined in Section 851 of the Internal Revenue Code (IRC) as domestic corporations which are either registered as management companies or unit investment companies under the 1940 Act or a common trust fund, with the following attributes: (a) it must file a return as a RIC; (b) at least 90% of its income must be from investing in stocks, securities or currencies; (c) it cannot hold more than 25% of its assets in securities of any one issuer or group of issuers controlled by the RIC. A RIC must generally distribute 90% of its earnings every year in order to qualify for pass-through entity treatment. Those distributions, made in the form of a taxable dividend, entitle the RIC to a dividends-paid deduction under IRC § 852(b)(2)(D). The most common form of RICs are mutual funds, designed to allow investors to pool their investments in securities with the benefit of professional management of the investments, without subjecting the investments to an entity-level layer of federal taxation. SEC rules also require the RIC to have at least 100 shareholders, like REITs.

The dividends-received deduction (DRD) is offset at the federal level by the imposition of corporate level tax on dividends received from the RICs, a tax treatment which runs counter to the usual rule established under IRC § 243 which allows a deduction for most ordinary domestic dividends paid between domestic corporations. The reverse treatment of dividends from RICs creates problems for state taxation in two instances. First, some states de-conform their tax base from the federal base with respect to dividends received, but not dividends-paid. As a result, all dividends received are entitled to a partial or total deduction, regardless of whether income tax was imposed on the entity paying the dividends. This non-conformity allows taxpayers with captive RICs to shield their profits from any state taxation because those states do also allow a dividends-paid deduction at the RIC level.

The second vulnerability arises from income combination rules for combined filing states, which require the elimination of inter-company dividends for members of a combined group. The base income of the RIC is computed after the dividends-received deduction is recorded, but the taxable dividend paid back to the operating company is eliminated by statutes designed to prevent double-taxation of what were assumed to be taxable dividends. This elimination process has the same effect of allowing a double-deduction of RIC dividends.

Most States Have Already Responded to the Double-Deduction Problem Through Legislation.

On August 7, 2003, an article in the Wall Street Journal detailed how the accounting firm KPMG had created "captive" RICs for at least nine banks in order to reduce state taxation. According to subsequent reports in State Tax Notes (8/11/03 and 12/1/03), Bank of America led the way by shielding some $9 billion of securities transferred to a captive RIC to avoid taxation. Other banks included Imperial Bank, Cathay Bank, City National Bank, Washington Mutual, Inc., Zions Bancorp and Fleet Bank Network.

As those articles and subsequent audits have made clear, the effects of the RIC planning device are significant because the financial institutions transferring securities retain the expenses associated with creating those securities. For example, a bank will borrow money from Federal Reserve banks to make mortgage-backed loans to its customers. The mortgage notes are transferred to a RIC and customer payments are sent to the RIC (usually indirectly in the form of pooled mortgage portfolios). The RICs then pay a dividend back to the operating companies in the form of a non-taxed dividend. The banks continue to service the mortgage notes and are thus saddled with both income and servicing expenses, but receive none of the mortgage payments as gross income.

Partially as a result of the Wall Street Journal article, the states moved quickly to increase their audit activities and passed legislation to address problems with double-deductions of dividend income. States which legislatively responded to the double-deduction or elimination problem included California, Rhode Island, Massachusetts, North Carolina and New York. According to the MTC's audit staff, some Compact states continue to have a double-deduction problem arising from dividends-received non-conformity or have not changed their combined return elimination rules to clarify that elimination of dividends is appropriate only where the dividend payor has been subjected to tax on its net income.

The Current Extent of the Captive RIC Problem is Unclear.

2003 appears to have been a watershed year for use of captive RICs. As a result of many factors, including increased state audit activity, legislation addressed to double-deductions or eliminations, anti-sheltering activity, and apparently, actions by the Securities and Exchange Commission (SEC), many financial institutions appear to have discontinued the use of captive RICs as a tax avoidance mechanism. This shift was referenced in the fiscal impact report prepared by the California Franchise Tax Board for SB 103, the legislation which fixed California's purported combination elimination problem. In earlier fiscal impact reports, California estimated the tax benefits at $45 million for 2004, going up to $65 million in 2006. The amended FIR, however, prepared in September of 2003, estimated the fiscal impact at $10 million in 2004 and negligible afterwards.

Anecdotally, it appears that many financial institutions began to unwind their RIC transactions in 2000 and had wrapped up the use of RIC by 2002. The financial institutions did not abandon the practice of isolating income flows from the operating entities, but apparently have elected to use captive REITs instead. (REITs are able to hold mortgage-backed securities.)

MTC's audit staff reports that it has not seen captive RICs in any of the bank audits it has recently completed or which are still underway. An informal poll of some litigation committee members and some state audit staffs likewise suggests that RICs are not being used currently by financial institutions. Captive REITs continue to be used by many financial institutions, however.

It is not clear whether the captive RIC strategy is or has been used outside of the financial institutions industry. A RIC's assets must be diversified; the value of its holdings in securities from related entities cannot exceed 25%. IRC § 851(b)(4)(B). This limitation would make it difficult for an entity which does not deal in securities, such as loans, from creating a RIC to hold its own intangible assets. According to some taxpayer planning documents, however, complicated strategies may be available to side-step this requirement. The extent of use by non-financial institutions, is simply unknown at this time. In theory, any business entity with account receiveables could securitize those receiveables and place the securities into a RIC in order to convert that income into a dividend payable to a non-taxed entity. The RIC would also have to include a significant pool of securities from unrelated entities.

Some Proposed Solutions to the Captive RIC Problem.

A. Combined States.

For combined filing states, the solution to the RIC problem seems to be straightforward. First, define a "captive" RIC as one with (a) majority ownership in a taxable corporation, directly or indirectly, and (b) an entity not regularly traded on public markets.
Second, deny the dividends-paid deduction of Section 852 for these captive RICs.

Alternatively, combined filing states could continue to allow the DPD if they ensured that their dividends-received treatment (and dividend elimination rules) were consistent with federal base income calculations. This approach may have a serious drawback. With respect to captive REITs, the MTC audit staff has discovered that the REIT dividends are sometimes diverted to non-combined entities, such as captive insurance companies or 80/20 companies. The RIC structures currently being litigated in California and elsewhere do not seem to use this approach—the double-deduction arises under former law only because the recipient is a part of the combined group. There is nothing inherent in RIC regulation or taxation, however, which would prevent entities from using non-combined entities to receive taxable dividends. The denial of the dividends-received deduction would appear to make the most sense.

In addition, because of the possibility of double-taxation of legitimate RICs that may fall within the captive RIC definition, a general statement of intent not to double-tax dividends, as Illinois recently adopted in its RIC/REIT legislation, should be considered as a minimum, perhaps in lieu of a more extensive tax credit system such as that found in the MTC's add-back model statute.

B. Separate-Fling States.

For separate-filing states, denying the dividends-paid deduction alone would appear to be problematic. Captive RICs can easily be established in low tax states like Delaware or Nevada. In the most common scenario of banks transferring loan portfolios to RICs, it would be very difficult (but not impossible) for the states from which those loan portfolios originated to assert nexus over the RIC, based on the location of the loan customers. The nexus difficulties arise because the loans are bundled into separate financial instruments before transfer, and, as planning documents indicate, special purpose subsidiaries are created to hold those bundled securities prior to transfer to the RICs.

An alternative would be to define captive RICs by statute and to provide that any such RIC shall be treated as a division of the majority owner, with ownership measured directly or indirectly. This approach is not foolproof because, as planning documents indicate, RIC ownership is sometimes held by a holding company above the operating company or could be held by other non-nexus companies.

A third approach would be to require an add-back of amounts paid to the RIC. Unfortunately, RICs are established to receive periodic payments, usually interest, from third parties; unlike rental payments to a captive REIT, RICs do not generate deductible expenses for the operating company.

A fourth approach would be to attempt to unwind the entire series of transactions creating the RIC in order to align the expenses of creating the securities (e.g., interest on borrowings) with the return on those expenses in the form of loan repayments from third parties. In this effort, a definition of a captive RIC would be helpful, coupled with a statutory presumption that such RICs were established for tax purposes and should not be respected. Because such tax planning involves multiple levels of entities and transactions, the net effect of such non-recognition cannot be predicted in advance.

Conclusion.

The MTC's proposed model statute for REITs could be easily modified for use for combined filing states in combating abusive RICs. The solution for separate entity states will require further study if it is to be effective in the future. States are urged to share information on the current use of RICs so that our proposals can reflect known practices.

A discussion draft of a proposed model for taxation by combined filing states, which may also be of some benefit to separate-filing states, is attached as Exhibit A:

Exhibit A:

2008 DRAFT
FOR DISCUSSION PURPOSES ONLY

Proposed Model Statute for Taxation of
Captive Regulated Investment Companies

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

b. The term "captive regulated investment company" means a regulated investment company (a) that is not regularly traded on an established securities market, and (b) more than 50% of the voting stick of which is owned or controlled, directly or indirectly, by a single corporation that is not exempt from federal income taxation and is not a regulated investment company.

c. In computing the tax on captive regulated investment companies imposed by [state corporate income/banking tax statute] the dividends-paid deduction otherwise allowed by federal law in computing net income of a regulated investment company under Section 852(b)(2)(D), as amended, shall be added back into taxable income.

d. For purposes of this section, the constructive ownership rules of Section 318(a) of the Internal Revenue Code of 1986, as amended, as modified by Section 856(d)(5) of the Internal Revenue Code of 1986, as amended, shall apply in determining the ownership of stock, assets, or net profits of any person.

e. [Tax Credit--For Separate Entity States or Combined Filing States That Do Not Eliminate Inter-company Dividends]:

   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 dividends received from a captive Regulated Investment Company, the dividend recipient shall receive a credit against tax due in this state in an amount equal to the tax paid by the captive Regulated Investment Company with respect to the dividends added back into taxable income, net of any credits or offsets against that liability. The credit so determined shall be multiplied by the apportionment factor of the dividend recipient in this state. However, in no case shall the credit exceed the taxpayer's liability in this state attributable to the dividends received from the Captive Regulated Investment Company.