MULTISTATE TAX COMMISSION

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MEMORANDUM

To: Wood Miller, Income and Franchise Tax Uniformity Subcommittee Chairman, and Members of the Income and Franchise Tax Uniformity Subcommittee

From: Bruce Fort, MTC Counsel

Date: November 20, 2009

Re: Proposed Model Statute For Disallowance of Deductions for Certain Payments to Captive Real Estate Investment Trusts

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At the last meeting of the Income and Franchise Tax Uniformity Subcommittee in July 2009, the Subcommittee formed a drafting group for the purpose of drafting a proposed model add-back statute for payments made to real estate investment trusts. The drafting group consists of Wood Miller, Frank O'Connell of the Georgia Department of Revenue, and Joe Garrett of the Alabama Department of Revenue. The drafting group met telephonically on five occasions in October and November 2009 to develop a draft model statute. A draft proposed model statute is attached hereto for review.

In 2007, the Commission adopted a Model Statute Denying the Dividends-Paid Deduction for Captive Real Estate Investment Trusts (REITs). The Model Captive REIT Statute was a response to evidence that some corporations had misused the REIT tax structure to shift income to no or low tax states.[1] The model statute should work well in combined filing states as it acts to retain the income within the combined group. The model statute may not work as well for states which impose taxes allowing separate-entity filing. A taxpayer can avoid shifting ownership of real estate located in the

[1] The income is shifted as follows: an operating company with significant investment in real estate transfers its legal interests in that real estate to a captive REIT. The operating company must now pay rent to the REIT for the continued use of those properties even though the operating company continues to bear the historic expenses of purchasing and developing the real estate. The operating company also takes a deduction on its federal and state tax returns for the amounts paid as rental expense. The captive REIT is required to pay out 90% of its income annually in the form of dividends, but it is entitled to deduction for dividends paid. The REIT dividends should be subject to tax in the hands of the REIT's shareholders. A captive REIT designed to shift will pay its dividends to an entity which is not subject to state income taxes or which is beyond the jurisdictional reach of the states. The income is then either loaned back to the operating company or is repatriated as a deductible ordinary domestic dividend under IRC Section 243.

separate entity states which have adopted the model statute, while still receiving the benefits of a deduction for real estate rental expenses for property located in other jurisdictions. Disallowing the operating company's federally-allowed deduction for rental expense paid to a captive REIT keeps the income within the taxing jurisdiction and ensures that the disallowed amounts will be apportioned among the states according to the operating company's factors.

The drafting group looked at current add-back legislation from Georgia, Oklahoma and Wisconsin. The drafting group also reviewed the MTC's model add-back statute. The drafting group decided to explore a modification of Georgia's add-back statute, which goes into effect in 2010. Ga. Code Section 48-7-28.4. The draft model statute also incorporates some elements from Wisconsin's add-back statute.

1. Brief Description of the Draft Model Statute:

The model statute provides for an add-back of "expenses and costs" paid to a captive REIT. That add-back amount is reduced in two ways: first, to the extent the REIT reduces its income by payment of "expenses and costs" to third parties, the taxpayer is entitled to reduced the amount of its add-back by a proportionate amount; second, by allowing a reduction of the add-back for amounts paid by the captive REIT or its shareholders to the taxing state or other states. A reporting requirement is imposed on the taxpayer with a 10% non-disclosure penalty as well as denial of any adjustment to the amounts added back. The tax commissioner is also given authority to make adjustments to the add-back requirement, but only to the extent those adjustments would be allowed by other state laws and practices.

2. Section-by-Section Analysis:

Section (a)(1) of the model statute contains the primary definitions of a Real Estate Investment Trust, including certain foreign trusts having REIT characteristics. The definition is taken from the MTC's current model statute. Section (a)(2) defines a "captive REIT". This definition is also identical to that found in the MTC's current model statute.

Section (b) of the model statute imposes the requirement to add-back "all expenses and costs directly or indirectly paid" to a captive REIT, on a pre-apportioned basis.

Section (c) of the statute provides for a reduction to the amount of required add-back to the extent the captive REIT pays expenses to unrelated parties. For instance, if a REIT received $1,000,000 in total rental payments from a taxpayer but paid $500,000 to a third party for sub-rents, and claimed $300,000 in other expenses, the taxpayer would only be required to add back $200,000 into its taxable income.

Section (d) of the model statute provides for a further reduction of the add-back to the extent the REIT <u>or its shareholders</u> pays state income tax to any State on its net income at an effective tax rate to be established by the individual states. In the example described

above, if the REIT's $200,000 net income was paid as a dividend to shareholders, and that income was subject to tax in the hands of the shareholders at an effective tax rate in excess of the amount established by statute, the taxpayer would not be required to add back any amount of expenses paid to the REIT. The drafting committee believes that states may want to consider further definitions of how to calculate effective tax rates, but that such definitions may be appropriately handled by regulation.

Section (e) imposes a requirement that a taxpayer must disclose its payments to captive REITs. A taxpayer that has failed to disclose those payments will not be allowed to reduce its add-back by the amounts paid by the REIT's expenses or taxes paid by the REIT or its shareholders.

Section (f) provides that the statute should be construed to avoid double-taxation of any payments.

Section (g) provides that federal definitions of constructive ownership shall apply to determine whether parties are related to one another.

Section (h) provides an additional penalty of 10% of tax due for failure to make the disclosure required in Section (e), with an exception for reasonable cause or simple negligence.

Section (i) provides that the statute does not negate any powers of the Commissioner to modify or adjust tax liabilities found elsewhere in state tax codes.

Section (j) grants authority to the Commissioner to promulgate forms and regulations to effectuate the statute's purpose.

4 Additional Considerations:

A. The states should be aware that this draft model statute will have no effect on "captive" mortgage REITs held by financial institutions. The drafting group is aware that financial institutions can use the REIT structure to shift income outside of the taxing jurisdictions, but believes that problem must be addressed separately, possibly in a statute addressed to taxation of financial institutions.

B. The drafting group considered several variations of the Section (d), the credit for taxes paid. After much deliberation, the drafting group elected not to include a test for whether a taxpayer or its shareholders are "subject to tax" on REIT income on an apportioned basis. Instead, the drafting group determined that it would be administratively easier to set a trigger for when income has been subject to an effective tax rate high on a cumulative basis (at both the entity level and the shareholder level). Once that trigger is exceeded, no add-back of the related expenses would be required. The draft model leaves it to the states to determine the appropriate amount for an "effective tax rate" trigger.

C. The drafting group also determined that a detailed calculation for the "effective tax rate" would unduly lengthen and complicate the draft model statute. The drafting group believes that a relatively small number of taxpayers will be subject to the model statute since it covers only payments to captive REITs. The drafting group believes that because captive REITs are intended to avoid state taxation, it is unlikely that they will have an effective tax rate approaching the trigger amount in most instances. With the benefit of administrative experience, the states may desire to promulgate a regulation on the subject.

D. One significant difference between this add-back statute and the MTC's model add-back statute for intangible expenses and interest is that the credit for taxes paid will include taxes paid by the REIT's shareholders. The drafting group felt this was appropriate given the pass-through nature of REITs.

5. Status of Project:

The Income and Franchise Tax Subcommittee will review the model at our upcoming meeting on December 1, 2009.

Attachment:

Draft Model Dated 11/20/09