MULTISTATE TAX COMMISSION

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: February 19, 2010

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

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I have attached to this memorandum the latest version ("February 2010 Draft") of a proposed model statute which provides for the "add-back" of amounts paid by an operating company to a majority owned "captive" Real Estate Investment Trust (REIT) for purposes of determining state taxable income. The purpose of this memorandum is to explain the changes made to previous versions and to provide some background for the project.

The Income and Franchise Tax Uniformity Subcommittee called for the formation of a drafting group in July 2009 for the purpose of drafting a proposed model add-back statute for payments made to "captive" real estate investment trusts.[1] The project was commenced because of concern that taxpayers in separate-entity states could continue to take inappropriate deductions for rental amounts paid to "captive" REITs even if states adopted the MTC's 2008 proposed model statute denying the dividends-paid deduction ("DPD") provided for under Section 857 of the Internal Revenue Code ("IRC"). Denying the DPD would not be effective to prevent inappropriate income shifting if the separate-entity states lacked nexus in those states.

A. Summary of Recent Changes.

On February 3, 2010 the subcommittee considered the drafting group's latest proposal. At that meeting, comments were received from subcommittee members and

[1] The drafting group consists of Wood Miller of the Missouri Department of Revenue, Frank O'Connell of the Georgia Department of Revenue, Joe Garrett of the Alabama Department of Revenue, with John Foster of the Georgia DOR providing additional guidance.

from Dara Bernstein of the National Association of Real Estate Investment Trusts (NAREIT). Some changes were made to the draft to reflect the concerns raised at the February 3, 2010 meting. First, NAREIT expressed concern that the draft's definition of a REIT differed from the MTC's earlier model statute (which provided for the disallowance of the federal dividends-paid deduction ("DPD") under Section 857 of the Internal Revenue Code ("IRC") for captive REITs). In particular, the earlier draft defined a REIT as an entity electing REIT status under IRC Section 856. NAREIT pointed out that the election of REIT status happens at the time a federal return is due, which can be up to nine months after the close of the tax year. The February 2010 Draft now utilizes the same definition employed by the DPD model statute, which simply references an entity provided for under IRC Section 856.

Second, NAREIT expressed concern that the earlier draft did not differentiate between a REIT owned by a C-corporation (a "captive" REIT) and a "qualified" REIT owned by another REIT or various foreign investment vehicles. The failure to differentiate was the result of an error made in drafting. The February 2010 Draft corrects the drafting error by copying the definitions found in the MTC's previous DPD model statute.

The February 2010 Draft has another significant change from earlier drafts and the DPD model statute. The earlier versions provided that a closely-held or majority-owned REIT which is "intended to be publically traded" does not become a "captive REIT" if it becomes publically traded within one year of its election of REIT status. If the REIT does not go public in that period, the earlier drafts (and the MTC's DPD model) provide that the REIT would be considered a "captive" REIT retroactively *to the date of its election* to be treated as a REIT. The election of REIT status is made by "checking the box" at the time the first return is filed, which might not occur until 21 months after the REIT's formation (12 months plus 9 months for federal extensions). The drafting committee felt that this "latency" period might permit continued tax planning through the formation of serial short-term captive REITs that never actually become publically-traded. The February 2010 Draft now provides that a REIT that does not become publically traded within one year of its formation will be treated as a captive REIT retroactively to the formation date.

B. Summary of Operation of February 2010 Draft.

The February 2010 Draft provides for an add-back of "expenses and costs" paid to a captive REIT by a taxpayer. That add-back amount is reduced 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. In addition, the February 2010 Draft provides a safe-harbor where the captive REIT or its shareholders pay an effective rate of tax (set by the states) on its net income. 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.

1. Section-by-Section Analysis:

Section (a)(1) of the model statute contains the primary definitions of a REIT. Section (a)(2) defines a "captive REIT", and (a)(3) lists the exceptions to captive REIT status where majority ownership is held by another publicly-traded REIT or certain foreign trusts having REIT characteristics. The definition is taken from the MTC's current DPD model statute. Sections (a)(4) and (a)(5) define "related entity" and "related members", respectively.

Section (b) explains constructive ownership rules for determining majority ownership.

Section (c) explains the one year "incubation" period for closely-held REITs and the consequences of failing to go public within one year (the REIT will be treated as a captive, retroactively to the beginning of the tax period to which its REIT election applies).

Section (d) 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 (e) 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 (f) of the model statute provides for the elimination of the add-back requirement if the REIT <u>or its shareholders</u> pays state income tax to any State on its net income at minimum 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 (g) 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 (h) provides that the statute should be construed to avoid double-taxation of any payments.

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

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

C. Status of Project.

The drafting group believes the February 2010 Draft should prove effective in prevent operating companies from claiming inappropriate deductions for amounts paid to captive REITs in many situations and may prove to be a superior model for preventing income shifting, especially in separate-entity states. The February 2010 Draft's definition of a "captive" REIT differs slightly from the MTC's earlier DPD model statute by requiring a closely-held REIT to go public within one year of the effective date of its election, rather than one year from date an election is made. The February 2010 Model is being presented to the subcommittee for further comments and possible action. If the proposal is approved by the subcommittee and full uniformity committee in March it could be presented to the executive committee at its next meeting for consideration of proceeding to a public hearing.

Attachment:

February 2010 Draft

PROPOSED MODEL STATUTE FOR DISALLOWANCE OF DEDUCTIONS FOR PAYMENTS TO CAPTIVE REAL ESTATE INVESTMENT TRUSTS

(a) As used in this [Section], the term:

(1) 'Real estate investment trust' [shall have the meaning ascribed to such term in Section 856 of the Internal Revenue Code, as amended].

(2) 'Captive real estate investment trust' means any real estate investment trust the shares or beneficial interests of which are not regularly traded on an established securities market, and more than 50 percent of the voting power or value of the beneficial interests or shares of which are owned or controlled, directly or indirectly, or constructively, by a single entity that is:

(A) Treated as an association taxable as a corporation under the Internal Revenue Code of 1986, as amended; and

(B) Not exempt from federal income tax pursuant to the provisions of Section 501(a) of the Internal Revenue Code of 1986, as amended.

(3) ‘Association taxable as a corporation’, for purposes of applying paragraph (a)(2)(A) of this [section], shall not include:

(A) Any qualified real estate investment trust subsidiary under Section 856(i) of the Internal Revenue Code of 1986, as amended, other than a qualified REIT subsidiary of a 'captive real estate investment trust';

(B) Any Listed Australian Property Trust, meaning an Australian unit trust registered as a 'Managed Investment Scheme' under the Australian Corporations Act in which the principal class of units is listed on a recognized stock exchange in Australia

and is regularly traded on an established securities market, or an entity organized as a trust, provided that a Listed Australian Property Trust owns or controls, directly or indirectly, 75 percent or more of the voting power or value of the beneficial interests or shares of such trust; or

(C) Any qualified foreign entity, meaning a corporation, trust, association or partnership organized outside the laws of the United States and which satisfies the following criteria:

(i) At least 75 percent of the entity's total asset value at the close of its taxable year is represented by real estate assets, as defined at Section 856(c)(5)(B) of the Internal Revenue Code of 1986, as amended, thereby including shares or certificates of beneficial interest in any real estate investment trust, cash and cash equivalents, and U.S. Government securities;

(ii) The entity is not subject to tax on amounts distributed to its beneficial owners, or is exempt from entity-level taxation;

(iii) The entity distributes at least 85 percent 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;

(iv) Not more than 10 percent of the voting power or value in such entity is held directly or indirectly or constructively by a single entity or individual, or the shares or beneficial interests of such entity are regularly traded on an established securities market; and

(v) The entity is organized in a country which has a tax treaty with the United States.

(4) “Related entity” means a stockholder who is an individual, or a member of the stockholder's family enumerated in Section 318 of the Internal Revenue Code of 1986, as amended, if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially, or constructively, in the aggregate, at least 50 percent of the value of the taxpayer's outstanding stock; a stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts, and corporations own directly, indirectly, beneficially, or constructively, in the aggregate, at least 50 percent of the value of the taxpayer's outstanding stock; or a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of section 318 of the Internal Revenue Code of 1986, as amended, if the taxpayer owns, directly, indirectly, beneficially, or constructively, at least 50 percent of the value of the corporation's outstanding stock. The attribution rules of 26 U.S.C. §318 shall apply for purposes of determining whether the ownership requirements of this subdivision have been met.

(5) "Related member" means a person that, with respect to the taxpayer during all or any portion of the taxable year, is: (A) a related entity, (B) a component member as defined in subsection (b) of section 1563 of the Internal Revenue Code as amended; (C) a person to or from whom there is attribution of stock ownership in accordance with subsection (e) of section 1563 of the Internal Revenue Code of 1986, as amended; or (D) a person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (A) to (C), inclusive.

(b) 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.

(c) For purposes of this section, a real estate investment trust that is intended to be regularly traded on an established securities market shall not be deemed a captive real estate investment trust within the meaning of this section if it becomes regularly traded on an established securities market within one year of the beginning of the tax period for which its election to become a real estate investment trust becomes effective.

(d) For purposes of computing [State] taxable net income, a taxpayer shall add back all expenses and costs directly or indirectly paid, accrued, or incurred to a captive real estate investment trust. Such expenses and costs shall be added back in the calculation of [State] taxable net income before the income is apportioned or allocated as provided by [UDITPA].

(e) The amount of the adjustment required by subsection (d) of this section shall be reduced, but not below zero, to the extent the corresponding expenses and costs received as income by the captive real estate investment trust are reduced by a proportionate amount of the expenses allowed in computing the captive real estate investment trust's federal taxable income that have not been paid, accrued or incurred by the captive real estate investment trust to persons that are related members.

(f) No adjustment shall be required under subsection (e) of this section if:

(1) the expenses and costs are received as income in an arm's length transaction by the captive real estate investment trust; and,

(2) the tax paid by the captive real estate investment trust and its shareholders on the corresponding income, when divided by the expenses and costs minus any adjustment in (c), yields an effective tax rate of not less than ___%.

(g) In claiming the reduction allowed by subsection (e) or the elimination of the add-back requirement in (f), the taxpayer shall disclose on its return, with respect to the captive real estate investment trust and its shareholders, the name, the federal identification number, the name of each state, the amount of the expenses and costs allocated or apportioned to and taxed by each state, and such other information as the commissioner may prescribe. Failure to make this disclosure on the return shall preclude the taxpayer from utilizing the reductions provided in those subsections.

(h) Nothing in this section shall require a taxpayer to add to its [State] taxable net income more than once any amount of expenses and costs that the taxpayer pays, accrues, or incurs to a captive real estate investment trust.

(i) In addition to other penalties imposed by [this title], the penalty for failure to make the adjustment required by this section shall be 10 percent of the additional tax that results because of this section. The Commissioner may waive this penalty when the Commissioner determines that the failure to make the adjustment required in subsection (d) was due to reasonable cause and not due to gross negligence or willful neglect or disregard of the law.

(j) Nothing in this section shall be construed to limit or negate the Commissioner's authority to:

(1) make adjustments under [cite to state’s Section 482 authority, if any];

(2) use alternative apportionment rules as allowed by [cite to state codification of UDITPA Section 18 authority, if any]; or

(3) enter into agreements and compromises otherwise allowed by law.

(k) The Commissioner is authorized to prescribe forms and promulgate rules and regulations deemed necessary in order to effectuate this section."