MEMORANDUM

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

From: Bruce Fort, MTC Counsel

Date: July 17, 2009

Re: Project to Amend Model Statute on Add-Back of Interest and Intangible Property Expenses Paid to Subsidiary to Include Rental Payments to Captive Real Estate Investment Trusts.

At the last meeting of the Income and Franchise Tax Uniformity Subcommittee in March, 2009, the Committee agreed to continue the project to explore a possible amendment to either the Model Uniform Add-Back Statute adopted by the Commission in 2004, or the Model Statute Denying the Dividends-Paid Deduction for Captive Real Estate Investment Trusts (REITs), adopted by the Commission in 2007.

The Captive Model REIT statute was a response to tax planning efforts by some corporations to shift income to low-tax jurisdictions through the use of a wholly-owned (“captive”) REIT, by transferring an operating company’s real estate assets to that REIT, which then charges the transferor company rent for the use of those properties. The operating company continues to bear the historic costs of developing the properties yet also now incurs the expense for using the properties. The REIT receives rental income for the use of this property from the transferor but generally avoids tax on that income by paying out dividends to shareholders nominally located outside of any taxing jurisdiction. The dividends generate a dividends-paid deduction for federal tax purposes, IRC Sec. 857, thus reducing the REIT’s taxable income to zero. (Because REITs were intended as investment vehicles for small investors, the IRC requires the REIT to pay out at least 90% of its income in dividends each year with the assumption that the investor will pay individual income tax on the earnings.) See generally, Bridges v. AutoZone, Inc., 900 So.2d 784 (La. 2005), for a description of the tax avoidance mechanism at issue.
As previously discussed in several meetings and memos, the Model Captive REIT Statute is effective for combined filing states because it de-conforms base income determinations from the federal dividends-paid deduction, thus retaining the income within the combined group. For separate-entity states, however, the Model Captive REIT Statute is less effective in preventing income-shifting because the taxpayer can control which real estate is transferred to the captive REIT. A taxpayer can avoid shifting ownership of real estate located in the state which has adopted the model statute, but still receive the benefits of a deduction for real estate rental expenses for real estate located in other jurisdictions, since “base income” for separate entity filers is generally computed on a national (“everywhere”) basis, and then subject to apportionment and allocation. Imposing tax on a captive REIT deriving income from property located in other jurisdictions would be futile since the REIT would have little or no presence within the taxing state, but the operating entity would still enjoy the benefits of a deduction for rental expenses paid in those jurisdictions.

Current Rental Expense Add-Back Statutes

Three separate-entity states responded to the problems created by nexus limits on taxing REITs by enacting legislation denying rental expense deductions paid to a captive REIT. Those states are Wisconsin, W.S.A. 71.05, Oklahoma, Okla. St. Ann. Sec. 2358, and most recently, Georgia, S.B. 379, effective for the 2010 tax year. The statutes are discussed below. Wisconsin has now adopted combined reporting and appears to have repealed much of its prior add-back legislation.

Model Add-Back Statutes and Model Captive REIT Statutes Compared

The two current model statutes apply very different methodologies to the problem of preventing abusive tax shifting without unduly burdening taxpayers or “overtaxing” income. The model add-back statute applies broadly to any interest or intangible income expense paid to a related entity but provides two expansive categories of exceptions to the “add-back” requirement. The first and most important exception is for taxes paid by the related entity. Defining the appropriate level of taxation paid by the related entity in order to trigger this safe-harbor has been difficult. The second exception is often discretionary and involves a determination of whether the intangible expense payments are “at arms-length” or “reasonable.” This discretionary authority has also proven to be difficult to administer; in addition, where assets have been transferred without taxation of any gains, a subsequent “arms-length” analysis of the rental price may miss the problem.

By contrast, the model REIT legislation contains no discretionary exceptions, and no exception for taxes paid, but defines the category of entities subject to its provisions very narrowly to only include the type of entity identified in the *Autozone* case as having no legitimate current or prospective investment vehicle purpose. Approximately twelve states have adopted some version of the model captive REIT statute since 2002, and so far, no litigation or controversies have been reported. This general acquiescence by taxpayers and the subsequent administrative silence suggests that: (a) the model works very well; (b) taxpayers have abandoned this tax planning technique; or (c) that the
model’s definition of “captive” REIT was not inclusive enough to prevent some abusive practices.

Because the two model statutes apply such different methodologies to prevent excessive taxation, it may not be advisable to incorporate the REIT concept into current interest and intangible expense add-back statutes or vice-versa, suggesting instead that a stand-alone statute might be advisable. On the other hand, income shifting techniques are probably not limited to use of the current categories of suspect expenses. In addition to interest and royalty expenses and rental payments to captive REITs, management fees and almost any other expense can be grossly overstated and thus allow income shifting. A broad statute covering many types of income can be more easily amended and modified.

Georgia:

Georgia has adopted a stand-alone REIT rental expense add-back statute that combines aspects of both statutory systems. The statute adopts a narrow definition of a “captive REIT” but also allows considerable statutory allowances for rental expense deductions where the captive REIT pays out expenses to unrelated third parties. This reduces the possibility of double-taxation to the extent the shareholders are also subject to taxation (although one could argue that the shareholders would not be taxes on such expenses anyway since the expenses would reduce federal taxable income of the REIT), but may be appropriate as an equitable adjustment where the related shareholders would otherwise lose the benefit of such deductions on properties transferred to the captive REIT for less than fair market value.

In addition, the Georgia statute allows a deduction for rental expenses paid where the captive REIT pays tax to separate entity states. The “taxes paid” provisions borrow concepts and definitions from various state add-back statutes. “Taxes paid” does not include amount paid by the REIT on a combined or consolidated return basis.

Finally, the Georgia statute has a broad administrative discretion standard. It has been reported that one potential adjustment of interest to the business community is the allowance of a rental deduction for the amounts of depreciation expense incurred by the REIT and lost to the former holders of the real property. In other words, transferring real estate to a captive REIT may provide for tax shifting opportunities, but will cause the transferor to lose the state tax benefits associated with depreciation expense. Such an equitable adjustment would serve to make the transferor “whole” in a sense but putting it back to its pre-tax planning position.

Oklahoma:

Oklahoma adopted a REIT rental add-back statute incorporating the model definitions of a captive REIT, and included interest paid to the captive REIT as part of the add-back legislation. In 2009, however, Oklahoma moved to exempt the operation of its add-back requirement where the captive REIT is “subject to tax” and files a return in
Oklahoma. Because a captive REIT may have a very small apportionment percentage within the state and yet still allow the operating company to artificially reduce reported income (for instance, the operating company could transfer only a single property in Oklahoma to its REIT while still expensing deductions for rent paid in hundreds of out-of-state stores), this legislative enactment may have significantly reduced the law’s effectiveness.

Wisconsin:

Wisconsin’s statute covered four types of expenses: interest, intangibles, rents and management fees. The statute provided three exceptions to the add-back requirement: (1) the related entity paid related expenses to an independent third party (as a conduit, for instance); (2) the related entity was “subject to tax” on such income; and (3) the Department was satisfied that the transactions with the related entity were entered into for substantial non-tax purposes and the transactions were at arm’s length. Some state legislatures might balk at providing such broad discretion to their tax administrators.

Excerpts from the three state’s statutes are found below. The subcommittee may wish to consider the establishment of a study group or drafting group to make further recommendations as to a preferred policy direction. I wish to extend thanks to Frank O’Connell of the Georgia Department of Revenue for his help on this project. Mr. O’Connell has studied these issues extensively and has offered to assist the subcommittee in any further efforts.

Excerpts From State Rental Expense Add-back Statutes:

Georgia:

48-7-28.4.

(a) As used in this Code section, the term:

(1) 'Association taxable as a corporation', for purposes of paragraph (2) of this subsection, does not include:

(A) A real estate investment trust as defined in this Code section, other than a 'captive real estate investment trust';

(B) 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';
(C) 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

(D) 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.

(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) 'Dividends paid deduction' means the deduction for dividends paid which is allowed
pursuant to Sections 561 through 565 and Sections 856 through 859 of the Internal
Revenue Code of 1986, as amended.

(4) 'Real estate investment trust' means an entity that has elected such status for federal
income tax purposes and meets the requirements of Section 856 of the Internal Revenue
Code of 1986, as amended.

(5) 'Related member' means the same as is defined in Code Section 48-7-28.3.

(b) For purposes of computing Georgia taxable net income under Code Sections 48-7-21
and 48-7-27, 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 before the income is apportioned or allocated as provided by Code
Section 48-7-31.

(c) The amount of the adjustment required by subsection (b) of this Code 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 expenses paid,
accrued or incurred to persons that are not related members, and such expenses shall be
allowed in computing the captive real estate investment trust's federal taxable income.

(d) The commissioner shall have the authority to reverse in whole or in part the
adjustments required in subsection (b) of this Code section when the taxpayer and the
commissioner agree in writing to the application or use of an alternative method of
apportionment under subparagraph (d)(2)(C) of Code Section 48-7-31, Code Section 48-
7-35, or Code Section 48-7-31.1. Nothing in this Code section shall be construed to limit or negate the commissioner's authority otherwise to enter into agreements and compromises otherwise allowed by law.

(e)(1) For purposes of this subsection, the term:
(A) 'Allocated or apportioned, or both' does not mean the amount of income that is subject to allocation or apportionment, or both. Rather it means the amount that is arrived at after applying the allocation and apportionment rules of a state as defined in subparagraph (B) of this paragraph. A tax or the portion of a tax, which is or would be imposed regardless of the amount of the income, shall not be considered to be a tax on or measured by the income of the captive real estate investment trust. (B) 'State' means a state in the United States of America, including the District of Columbia, but does not include those states under whose laws the taxpayer files with the captive real estate investment trust, or the captive real estate investment trust files with another related member, a combined income tax report or return, a consolidated income tax report or return, or any other report or return where such report or return is due because of the imposition of a tax on, or measured by, income and where such combined income tax report or return, consolidated income tax report or return, or other report or return results in the elimination of the tax effects from transactions directly or indirectly between the taxpayer and the captive real estate investment trust or between the captive real estate investment trust and another related member.

(2) The amount of the adjustment required by subsection (b) of this Code section shall be reduced, but not below zero, to the extent the corresponding expenses and costs are received as income in an arm's length transaction by the captive real estate investment trust and to the extent such income is allocated or apportioned, or both, to and taxed by Georgia or another state that imposes a tax on or measured by the income of the captive real estate investment trust. For purposes of this paragraph, the corresponding expenses and costs shall not be considered to have been received as income by the captive real
estate investment trust to the extent such income is reduced, in computing the income of the captive real estate investment trust in Georgia or another state, by the dividends paid deduction or by expenses paid, accrued, or incurred to persons that are not related members, or both.

(3) In claiming the exception allowed by this subsection, the taxpayer shall disclose on its return, with respect to the captive real estate investment trust, 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.

(f) Nothing in this Code section shall require a taxpayer to add to its Georgia 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.

(g) Nothing in this Code section shall be construed to limit or negate the commissioner's authority to make adjustments under Code Section 48-7-58.

(h) Except as otherwise provided in this Code section, a real estate investment trust that is intended to be regularly traded on an established securities market, and that satisfies the requirements of Section 856(a)(5) and (6) of the Internal Revenue Code of 1986, as amended, by reason of Section 856(h)(2) of the Internal Revenue Code of 1986, as amended, shall not be deemed a captive real estate investment trust within the meaning of this Code section.

(i) A real estate investment trust that does not become regularly 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 regularly traded on an established securities market, retroactive to the date it first became a real estate investment trust. For purposes of this subsection, a real estate investment trust becomes a real estate investment trust on the first day that it has both met the requirements of Section 856 of the Internal Revenue Code of 1986, as amended, and has elected to be treated as a real
estate investment trust pursuant to Section 856(c)(1) of the Internal Revenue Code of 1986, as amended.

(j) For purposes of this Code 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.

(k) The adjustment required by this Code section shall apply to a corporation that files a separate return with Georgia and to the separate taxable income computation of each member of a Georgia consolidated return.

(l) In addition to other penalties imposed by this title, the penalty for failure to make the adjustment required by this Code section shall be 10 percent of the additional tax that results because of this Code section. The commissioner may waive this penalty pursuant to the provisions of Code Section 48-2-43.

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

Oklahoma:

G. 1. For purposes of computing its Oklahoma taxable income under this section, a taxpayer shall add back otherwise deductible rents and interest expenses paid to a captive real estate investment trust. As used in this subsection:

a. the term “real estate investment trust” or “REIT” means the meaning ascribed to such term in Section 856 of the Internal Revenue Code of 1986, as amended, [FN8]

b. the term “captive real estate investment trust” means a real estate investment trust, the shares or beneficial interests of which are not regularly traded on an established securities market and more than fifty percent (50%) 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:

(1) treated as an association taxable as a corporation under the Internal Revenue Code of 1986, as amended, and
(2) not exempt from federal income tax pursuant to the provisions of Section 501(a) of the Internal Revenue Code of 1986, as amended. [FN9]

The term shall not include a real estate investment trust that is intended to be regularly traded on an established securities market, and that satisfies the requirements of Section 856(a)(5) and (6) of the U.S. Internal Revenue Code by reason of Section 856(h)(2) of the Internal Revenue Code,

c. the term “association taxable as a corporation” shall not include the following entities:

(1) any real estate investment trust as defined in paragraph a of this subsection other than a “captive real estate investment trust”, or

(2) 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”, or

(3) 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, seventy-five percent (75%) or more of the voting power or value of the beneficial interests or shares of such trust, or

(4) 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:

(a) at least seventy-five percent (75%) of the entity's total asset value at the close of its taxable year is represented by real estate assets, as defined in 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,

(b) the entity receives a dividend-paid deduction comparable to Section 561 of the Internal Revenue Code of 1986, as amended, or is exempt from entity level tax,

(c) the entity is required to distribute at least eighty-five percent (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,

(d) not more than ten percent (10%) 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
(e) the entity is organized in a country which has a tax treaty with the United States.

2. For purposes of this subsection, 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.

**Wisconsin:**

The “net income” of a corporation means the gross income as computed under the Internal Revenue Code as modified under sub. (3) and modified as follows:

7. Plus the amount deducted or excluded under the Internal Revenue Code for interest expenses, rental expenses, intangible expenses, and management fees that are directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related entities.

8. Minus the amount added to gross income under subd. 7., to the extent that the conditions under s. 71.80(23) are satisfied.

9. Minus the amount added, pursuant to subd. 7. or s. 71.05(6)(a)24., 71.34(1k)(i), or 71.45(2)(a)16., to the federal income of a related entity that paid interest expenses, rental expenses, intangible expenses, or management fees to the corporation, to the extent that the related entity could not offset such amount with the deduction allowable under subd. 8. or s. 71.05(6)(b)45., 71.34(1k)(k), or 71.45(2)(a)17.

**Related entity addbacks.** (a) The deductions provided under ss. 71.05(6)(b)45., 71.26(2)(a)8., 71.34(1k)(k), and 71.45(2)(a)17. shall be allowed for any interest expenses, rental expenses, intangible expenses, or management fees described in ss. 71.05(6)(a)24., 71.26(2)(a)7., 71.34(1k)(i), or 71.45(2)(a)16. if any of the following applies to the interest expenses, rental expenses, intangible expenses, or management fees:

1. The related entity to which the taxpayer paid, accrued, or incurred the interest expenses, rental expenses, intangible expenses, or management fees during the taxable year directly or indirectly paid, accrued, or incurred such amounts in the same taxable year to a person who is not a related entity or the related entity to which the taxpayer paid, accrued, or incurred such expenses or fees is a holding company or a direct or indirect subsidiary of a holding company, as defined in 12 USC 1841(a) or (l) or 12 USC 1467a(a)(1)(D), not including any entity that is organized under the laws of another jurisdiction and that primarily holds and manages investments of a bank, subsidiary, or affiliate. For purposes of this subdivision, “interest” does not include interest that is paid in connection with any debt that is incurred to acquire the taxpayer's assets or stock under section 368 of the Internal Revenue Code. If a portion of such an interest expense, rental expense, intangible expense, or management fee is paid, accrued, or incurred in the same
taxable year to a person who is not a related entity, that portion shall be allowed as a deduction to the taxpayer.

2. The related entity was subject to tax on, or measured by, its net income or receipts in this state or any state, U.S. possession, or foreign country; the related entity's tax base in such state, U.S. possession, or foreign country included the income received from the taxpayer for the interest expenses, rental expenses, intangible expenses, or management fees; the related entity's aggregate effective tax rate applied to such income or receipts was at least 80 percent of the taxpayer's aggregate effective tax rate; and the related entity is not a real estate investment trust under section 856 of the Internal Revenue Code, other than a qualified real estate investment trust. For purposes of this subdivision, “any state, U.S. possession, or foreign country” does not include any state, U.S. possession, or foreign country under the laws of which the taxpayer files with the related entity, or the related entity files with another entity, a combined income tax report or return, a consolidated income tax report or return, or any other report or return that is due because of the imposition of a tax that is measured on or by income or receipts, if the report or return results in eliminating the tax effects of transactions, directly or indirectly, between either the taxpayer and the related entity or between the related entity and another entity.

3. The taxpayer establishes that the transaction satisfies any other conditions that the department considers relevant, based on the facts and circumstances, to determine that the primary motivation for the transaction was one or more business purposes other than the avoidance or reduction of state income or franchise taxes; that the transaction changed the economic position of the taxpayer in a meaningful way apart from tax effects; and that the interest expenses, rental expenses, intangible expenses, or management fees were paid, accrued, or incurred using terms that reflect an arm's-length relationship.

(b) Notwithstanding par. (a), the deductions provided under ss. 71.05(6)(b)45., 71.26(2)(a)8., 71.34(1k)(k), and 71.45(2)(a)17. shall not be allowed for any interest expenses, rental expenses, intangible expenses, or management fees that are directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related entities, if the aggregate amount paid, accrued, or incurred for those related entity transactions is not disclosed on a separate form prescribed by the department in the manner prescribed by the department.

9ad) “Qualified real estate investment trust” has the meaning given in s. 71.22(9ad).

(9am) “Related entity” means any person related to a taxpayer as provided under section 267 or 1563 of the Internal Revenue Code during all or a portion of the taxpayer's taxable year and any real estate investment trust under section 856 of the Internal Revenue Code, except a qualified real estate investment trust, if more than 50 percent of any class of the beneficial interests or shares of the real estate investment trust are owned directly, indirectly, or constructively by the taxpayer, or any person related to the taxpayer, during all or a portion of the taxpayer's taxable year. For purposes of this subsection, the constructive ownership rules of section 318(a) of the Internal Revenue Code, as modified
by section 856(d)(5) of the Internal Revenue Code, shall apply in determining the ownership of stock, assets, or net profits of any person.

(9an) For purposes of s. 71.05(6)(a)24. and (b)46., “rental expenses” means the gross amounts that would otherwise be deductible in the computation of Wisconsin adjusted gross income for the use of, or the right to use, real property and tangible personal property in connection with real property, including services furnished or rendered in connection with such property, regardless of how reported for financial accounting purposes and regardless of how computed.