Sheldon, Loretta--

Let me offer one specific drafting comment about the MTC proposed statute regarding partnership or pass-through entity income that is ultimately realized by an entity that is not subject to income tax, for which there is a public hearing to be held later today. To effectuate the intention expressed in the draft model statute that the model statute shall apply to a real estate investment trust, I think it is necessary to add an additional sentence at the end of the draft that states that, "In any case in which this section applies to the ownership of a REIT, the dividends paid deduction to which the REIT is entitled under the Code, to the extent attributable to the income taxed under this section, shall not be recognized."

The reason that I offer this specific suggestion is that what the draft does is to treat a pass through entity as a corporation for purposes of state tax law under the circumstances referenced in the draft. The draft states an intention to treat a REIT as such a pass through entity subject to re-characterization as a corporation for purposes of state tax law under these same circumstances. But in general a REIT is taxable as corporation under state tax law under the states’ present tax law subject to income tax at the corporate level to the extent that the REIT does not pay dividends. It is the fact that the REIT is entitled to a dividends paid deduction as a corporation that effectively gives the REIT pass through treatment. So to ensure that this pass through treatment is not obtained when the provisions of the draft model statute are implicated, the dividends paid deduction should be disallowed in such circumstances.

Some states have addressed tax equity issues like that addressed by this draft model statute in the context of a REIT that is "captively" owned by a corporation. In those "captive REIT" situations, in any case in which the state statute seemed to afford the REIT a dividends paid deduction and its controlling corporate owner, a dividends received deduction, the income of the REIT potentially escaped state income tax entirely. In those states, it has sometimes been the proffered solution of the state to deny the dividends received deduction of the corporation owning the controlling interest in the REIT to effectively subject the income of the REIT to one level of income tax. However, one cannot address the same general tax equity issue addressed by the draft model statute in the context of the ownership of the REIT by denying the dividends received deduction, as the "captive" entity owning the REIT in cases addressed by this draft model will have no income against which to take this deduction.

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MTC proposed statute regarding partnership or pass-through entity income

that is ultimately realized by an entity that is not subject to income tax
As Approved by the Income & Franchise Tax Uniformity Subcommittee

October 19, 2010

When 50 per cent or more of the capital interests or profits interest in an entity for which deductions would be allowed under section 162 of the Internal Revenue Code, 26 U.S.C. 162 and that would otherwise be treated as a partnership or disregarded entity for purposes of [insert applicable state tax or taxes] is owned, directly or indirectly, by [identify each entity type that is not subject to income tax and that state wants to cover under this provision, such as “an insurance company,”, with a citation to the state tax statute applicable to each such entity type], the net income [or alternative tax base] that passes through to such [name each entity type identified above, e.g. “insurance company.”] shall be taxed to the partnership or disregarded entity as if the partnership or disregarded entity were a corporation subject to tax under chapter [insert state statute]. To the extent applicable, income that is taxable to the partnership or disregarded entity pursuant to this section, and any related tax attributes and activities, shall be included and taken into account in a combined report filed under [insert state statute]. As used herein, the term “partnership or disregarded entity” shall include a real estate investment trust (REIT) within the meaning of Section 856 of the Internal Revenue Code of 1986, as amended.

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