MULTISTATE TAX COMMISSION

REPORT OF THE HEARING OFFICER

Proposed Model Statute For Disallowance of Deductions for Certain Payments to Captive Real Estate Investment Trusts
December 1, 2010

I. Introduction and Summary.

On July 29, 2010, the Executive Committee of the Multistate Tax Commission ("the Commission") authorized a public hearing on the proposed Model Statute for the Disallowance of Certain Payments to Captive Real Estate Investment Trusts. Bruce J. Fort was appointed as the hearing officer. A public hearing was held on September 14, 2010 after being duly noticed. No written or oral comments on the proposed model statute were received during the public hearing. The undersigned hearing officer recommends adoption of the proposed model statute for the disallowance of certain payments to captive REITs as an alternative for states that have chosen not to adopt the Commission's 2008 Proposed Model Statute for the Taxation of Captive Real Estate Investment Trusts ("the 2008 model statute").

As discussed below, the 2008 model statute is well-designed for use in those states which require "combined" filing by unitary corporations. That model, however, may not prevent some inappropriate income shifting in states which allow "separate-entity" calculation and imposition of corporate income tax liability. The current Proposed Model Statute For Disallowance of Deductions for Certain Payments to Captive Real Estate Investment Trusts ("the proposed model statute") should discourage many inappropriate uses of captive REITS to shift income away from taxable entities operating in "separate-filing" states.

II. Procedural Summary.

A. Development of the Proposal:

In 2006, the Income and Franchise Tax Subcommittee of the Uniformity Committee ("the Subcommittee") first undertook a project to address the use of "captive" Real Estate Investment Trusts ("REIT's") as a vehicle to shift income away from taxing jurisdictions. The Subcommittee's efforts culminated in adoption of the 2008 model statute in December of 2008. The 2008 model statute operates by de-conforming state tax codes from the federal "pass-through" treatment of REITs, by denying wholly-owned ("captive") REITs the federal deduction for dividends paid to its shareholders under

Internal Revenue Code Section 857. By ensuring that captive REITs were taxed at the entity level, states could avoid tax loses caused when federally-deducted dividends were paid to related companies outside the states' taxing jurisdiction. The 2008 Model Statute was patterned after captive REIT legislation based on the "dividends-deduction-denial" methodology that had already been adopted by several states. Some 12 states now have "dividends-deduction-denial" statutes addressed to REIT dividend treatment generally or dividends paid by captive REITs specifically.[1]

In March of 2009, the Subcommittee took up the question of whether it would be appropriate to consider an alternative model statute, one designed for "separate entity" state tax systems, to ensure that taxpayers could not continue to use captive REITs for inappropriate income shifting. The subcommittee approved the project in July of 2009 and a drafting group was formed. The drafting group, chaired by Frank O'Connell of Georgia with Wood Miller of Missouri and Joe Garrett of Alabama, was asked to determine the suitability of the Commission's 2006 Model Statute for the Disallowance of Deductions for Intangible Income and Interest Expense ("the 2006 model add-back statute") as a basis for a similar model statute addressed to captive REITs.

The drafting committee initially recommended it would be appropriate to employ a stand-alone statute denying deductions for certain payments to captive REITs, rather than to draft an amendment to the MTC's 2006 model add-back statute. The drafting group also recommended that it would be appropriate to follow the structure of the 2006 model, and where applicable, to employ the same substantive provisions and definitions. The drafting group also incorporated some aspects of "add-back" legislation Georgia had adopted in 2009. See Ga. Code Section 48-7-28.4.

The Subcommittee considered several versions of the proposed model in meetings held in 2009 and early 2010. In April 2010, the subcommittee voted to recommend the proposed model statute to the full Uniformity Committee. The Uniformity Committee recommended the model to the Executive Committee on May 13, 2010. Thirteen states voted in favor of recommending the proposed model statute to the Executive Committee for a public hearing pursuant to the Commission's Bylaw 7. One state abstained from the voting.

B. Public Hearing.

A Public Hearing was held telephonically on Tuesday, September 14, 2010, at 1:00 p.m. EST. The hearing had been duly noticed to the public via e-mail and posting on the Commission's web site more than 30 days prior to the hearing. See Attached Exhibit A, *Notice of Telephonic Hearing*, dated August 10, 2010. Several state and private sector representatives participated in the hearing but no written or oral comments on the proposed model statute were received prior to or during the hearing.

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[1] Those states include California, Massachusetts, Indiana, Illinois, Kentucky, Louisiana, Mississippi, Maryland, North Carolina, Utah, Rhode Island and New York**.**

Some comments from industry representatives were made before the Income and Franchise Tax Subcommittee as it considered earlier drafts of the proposed model. The National Association of Real Estate Investment Trusts (NAREIT) in particular made many helpful suggestions of a substantive and editorial nature through it counsel. With few exceptions, the subcommittee agreed to make changes to the various draft proposals in response to those suggestions. Comments from representatives of the REIT industry are discussed where relevant in the "Section by Section" analysis in Part III B 2, below.

III. Summary of Substantive Provisions:

A. Purpose of Proposed Model Statute:

This proposed model statute is intended to prevent the misuse of the Real Estate Investment Trust (REIT) tax structure as a means to reduce state corporate income and franchise tax liabilities. Currently, taxpayers with substantial real-estate holdings can transfer ownership of those holdings to wholly-owned REITs, creating an abusive deduction for the subsequent rental payments to those captive REITs on the taxpayer's state and federal tax returns. The deduction is "abusive" because the taxpayer incurred the expense of developing the real estate; the tax-free exchange of the real property for shares in the REIT allows the REIT to charge rent for property that cost it nothing. The REIT will report significant earnings since it paid nothing to develop the property it now owns. The taxpayer, meanwhile, has already taken deductions for the development costs; incurring a second deduction for rents paid to use that same property reduces its income in an abusive manner.

Because the Internal Revenue Code (IRC) allows REITs to claim a "dividends-paid deduction" on income paid out in the form of dividends, the rental income from the transferred property can escape state taxation if it is paid to shareholders who are not subject to tax. The shareholders may escape taxation because they are nominally located in a jurisdiction which does not impose an income tax, or the shareholders may be captive insurance companies or other business forms not subject to state income taxation.

The income from the REIT is ultimately repatriated to the operating company or a parent company in the form of an ordinary (deductible) domestic dividend, or in the form of a "loan", perhaps after passing through other subsidiaries or affiliates. In this manner, the income shifted to these captive REITs can be effectively insulated from state taxation.. The mechanics of the captive REIT scheme and income flows are described in detail in *Bridges v. AutoZone, Inc.,* 900 So.2d 784 (La. 2005).

Following the wide-spread adoption of "add-back statutes" in the late 1990's and early 2000's, many corporate taxpayers have established captive REITs as an alternative strategy to avoid state income taxes. The strategy is particularly common in the financial industry, since even derivative ownership of mortgage instruments qualifies as "real estate" meeting the 75% real estate ownership test in IRC Sec. 856(c)(5). Captive REITs have also been employed in the retail industries, including franchise restaurant chains.

Congress intended REITs to be an investment vehicle allowing small investors to pool their assets in order to receive professional investment services, without incurring taxes at the entity level that might discourage investment.[2] That is why, under IRC Section 856(a)(5), a REIT must have at least 100 shareholders and cannot be "closely held" after its first year for which it has elected to be treated as a REIT. IRC Section 856(a)(6). But, those provisions have not proved to be effective in preventing the use of captive REITs to shift income. While the great bulk of the REIT ownership is held by a single corporate subsidiary, very small amounts of beneficial ownership can be transferred to corporate officers or similar "insiders" in order to meet the 100 shareholder requirement of IRC § 856(a)(5). Neither the subsidiary nor the corporate insiders can be considered "investors" in real estate in any reasonable sense of the word.

Because captive REITs are not regulated and are unlikely to be publically-disclosed, it is difficult to estimate the extent of state tax losses incurred by their use. In 2007, the Wall Street Journal published an article on a captive REIT scheme created by Wal-Mart Stores, Inc. allegedly to reduce its state tax liability. J. Drucker, *Wal-Mart Cuts Taxes by Paying Rent to Itself*, Wall Street Journal, 2/10/07, page 1. Tax experts quoted in the article opined that Wal-Mart may have saved up to $350 million in state taxes in just four years. The article created considerable attention in state legislatures. *See also, Wal-Mart Stores, Inc. v. Hinton*, 676 S.E.2d 634 (N.C. App. 2009).

B. Operation of the Proposed Model Statute:

The proposed model statute disallows a corporate income taxpayer's deductions for certain amounts (generally rent) paid to a captive REIT by a related party. The proposed model statute defines a "captive" real estate investment trust as a REIT which is not traded on an established securities market and which is majority owned, directly or indirectly, by a single entity subject to taxation as a "C" corporation. The proposed model statute identifies several exceptions to the captive REIT definition for "qualifying" REITs which are not considered as vehicles intended to improperly minimize state tax. These are the same provisions found in the 2008 model statute. In addition, the model statute uses the same criteria for determining indirect or "constructive" ownership in the 2008 model statute, referencing two federal tests. The major difference between the 2008 model statute and the current proposed model statute is that the proposed model retains the income attributable to the value of the real estate in the operating company's pre-apportioned tax base, while the 2008 model statute imposes tax on the same income in the hands of the captive REIT.

[2] REITs share some of the tax attributes of simple trusts, most significantly the effective pass-through of income tax liability (but not losses) to the beneficial owners. REITs are not technically pass-through entities, as any undistributed income is subject to tax at the REIT entity level. Congress requires REITs to annually distribute at least 90% of their earnings as a dividend. The elimination of entity-level taxation is achieved through the allowance of a dividends-paid deduction under Internal Revenue Code (IRC) § 857; REITs are required to distribute at least 90% of current earnings on an annual basis. Corporations receiving REIT dividends are not permitted to claim a deduction for those dividends for federal tax purposes, in contrast to treatment afforded to ordinary domestic dividends under IRC § 243.

For states that allow taxpayers to report their income on a "separate entity" basis, keeping the income in the operating company's tax base is important because deductions are claimed on a pre-apportionment basis. Thus, a deduction claimed for payments to a captive REIT which nominally owns stores in "State A" will reduce the taxpayer's pre-apportioned income tax base in "State B" as well, even though no stores in State B have been transferred to the captive REIT. Imposing an apportioned tax on the captive REIT's income will not help State B recover its losses, because the captive REIT will have no apportionment factors in State B.[3] In short, even if a separate-entity filing state adopted the 2008 model statute, which taxes the rental income at the REIT level, taxpayers could still achieve significant tax reduction in that state by utilizing a well-designed REIT strategy which limited the captive REIT's ownership interests to properties located in other states.

It should be noted in the example above that if both State A and State B adopted the 2008 model statute, no income would escape taxation, but a portion of the tax base would be effectively shifted from State B to State A. State A would be entitled to tax 100% of the REIT's income.[4] If both State A and State B adopted the current proposed model, then no income would be shifted to the REIT and the taxpayer's tax liabilities to each state would remain unchanged. If State A adopted the 2008 model statute, and State B adopted the current proposed model, there would be a theoretical possibility that REIT income would be subjected to multiple taxation. The current proposed model eliminates the theoretical problem of double-taxation by including a "safe harbor" provision that eliminates the add-back of rental expenses if the REIT or its shareholders are subjected to an effective rate of state taxation above a certain level (setting the appropriate effective state tax rate is left to the enacting states).

1. Comparison of the Current Proposed Model Statute with the 2008 MTC Model Statue for Taxation of Captive REITs and 2006 MTC Model Statute for Add-back of Interest and Intangible Expenses.

The proposed model statute borrows definitions and mechanics from both the 2006 model "add-back" statute and the 2008 model statute denying the dividends-paid deduction. The 2006 add-back statute applies to a significant number of inter-company transactions and was accordingly designed with numerous "safe harbors" provisions to avoid "add-back" in appropriate circumstances. The 2008 statute, by contrast, applied to a very small number of transactions because the definition of "captive REIT" was very narrowly drawn to exclude the legitimate REIT industry from its operations. The current proposed model statute retains the narrow definition of "captive REIT" but also takes the

[3] The transfer of store ownership in State A will not increase the operating company's property factor denominator in State B, because the rental amounts paid in State A (multiplied by a factor of 8) will continue to be included that state's property factor under Article IV, Section 13 of the Multistate Tax Compact (UDITPA Section 13).

[4] Although State A would be entitled to tax all of the captive REIT's income, revenue losses could still occur through operation of the standard three-factor apportionment formula. For instance, if the captive REIT is "managed" by a handful of employees in a low-tax jurisdiction like Nevada, a taxpayer could argue that one third of the REIT's income should be sourced to that state because all of the REIT's payroll was there.

approach of allowing some exceptions to the add-back requirement. The first of these exceptions is a reduction in add-back to the extent the captive REIT has incurred certain expenses associated with ownership of the property that has reduced its own (pre-distribution) taxable income, including depreciation expenses. The second exception provides that if the REIT or its shareholders are subject to an effective tax on the rental income amounts above a certain threshold, no add-back is required. The proposed model would allow the states to determine that threshold percentage.

As set forth above, the Subcommittee concluded that there would be little or no possibility of "double taxation" if some states adopted the 2008 model statute while other states adopted the current proposed model statute, because the current model statute includes a "safe harbor" in the event the captive REIT or its shareholders are effectively subject to tax (the states are left to determine the appropriate tax rate).

It is important to note that neither the current proposed model statute nor the 2008 model statute address the problem of financial institutions misusing the REIT structure to shift income away from taxing jurisdictions, especially in separate-entity states. Income-producing securities may be easily transferred by a financial institution to a captive REIT, while the transferor retains the interest expenses associated with acquiring the securities. The obligators on those securities then make their payments directly to the REIT, leaving the operating company with expenses but no income. See, e.g., *T.D. Banknorth, N.A. v. Dept. of Taxes*, 967 A.2d 1148 (Vt. 2008). The current proposed model statute will not prevent this method of income shifting because the interest expenses deductions are incurred by an unrelated third party who cannot be forced to "add back" the amount of their deductions. And denying the dividends-paid deduction for the captive REIT under the 2008 model statute may be ineffective if the captive REIT is established as an "80/20" company, with a minimal amount of overseas real property or payroll. In addition, a REIT holding indirect real property interests, like pools of mortgage-backed derivatives, may also claim that the income should be sourced to its commercial domicile under "costs of performance" rules applicable to receipts from intangible property, instead of sourcing the income to the location of the underlying mortgaged property. The captive REIT will also typically have a minimal amount of payroll in Nevada, Delaware or overseas, which may distort the operation of the apportionment formula as applied to the income shifted to the REIT, when compared to the apportionment percentages of the operating company.

The 2006 model add-back statute would also not address a financial institution's use of a captive REIT structure to shift income, because the operating company transfers ownership of the mortgage instruments to the REIT, but does not make payments to the REIT, so there is no deductible amount to "add-back" to the operating company's taxable income base.

The Subcommittee instructed the drafting group to limit its efforts to the problems caused by transfer of true real estate assets (co-called "dirt" mortgages), believing that the problem of financial institutions transferring indirect real estate interests to captive REITs for tax advantages is addressed in separate uniformity efforts.

2. Section-by-Section Analysis of the Proposed Model Statute:

Section (a)(1) of the proposed 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 2008 MTC model statute denying the dividends-paid deduction. Sections (a)(4) and (a)(5) define “related entity” and “related members”, respectively by reference to IRC Sections 318(a) and 1563.

Section (b) explains constructive ownership rules for determining majority ownership under Section 381(a) and 856(d)(5). NAREIT suggested that these definitions of related entities, persons and constructive ownership could be simplified to avoid confusion. The subcommittee determined that the use of these definitions was appropriate, especially since they were taken from the 2006 and 2008 model statutes.

Section (c) addresses 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). This section improves upon the retroactivity provisions in the 2008 model statute by clarifying that a REIT which does not go public is deemed to be a captive REIT from the date of its formation, rather than from the end of the incubation period. This should prevent taxpayers from establishing serial REITs that might string together multiple incubation periods to avoid the 2008 model statute’s triggering event.

Section (d) of the proposed 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. The section includes payments for interest and other inter-company amounts that may not be considered rent. One commentator suggested during the subcommittee’s deliberations that an exception should be made for payments for services performed by related parties since the Internal Revenue service audits the amounts of such payments. The subcommittee concluded that making much an exception would create an unintended opportunity to avoid the proposed model statute’s effectiveness.

Section (e) of the proposed model 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 proposed 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 the income derived from the captive REIT at a 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 Subcommittee considered drafting detailed rules for how to calculate effective tax rates, but the Subcommittee believed the additional detail was unnecessary since relatively few taxpayers should be affected by the proposed model statute, and the effective tax rates for captive REITs and their shareholders would most likely be quite low. The Subcommittee felt that if states determine that more detail is appropriate, such detail 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 for expenses or taxes paid by the REIT or its shareholders. The subcommittee believed that disclosure of payments to captive REITs is important to the states' compliance efforts, even where it is subsequently determined that such payments should not trigger the add-back requirement.

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.

IV. Conclusion.

The hearing officer recommends that the Executive Committee consider authorization of a by-law 7 survey to the Multistate Tax Compact's member states of the Proposed Model Statute for Disallowance of Deductions for Payments to Captive Real Estate Investment Trusts attached hereto as Exhibit B.

Respectfully submitted,

Bruce J. Fort
Hearing Officer

December 1, 2010

Attachment:

Exhibit A (Notice of Hearing)