MULTISTATE TAX COMMISSION

Report of the Hearing Officer Regarding Proposed
Model Statute for Taxation of
Captive Real Estate Investment Trusts
October 2007

I. Introduction

On August 2, 2007, the Multistate Tax Commission (MTC) Executive Committee approved for public hearing an MTC proposed model statute for the taxation of captive Real Estate Investment Trusts (REITs). The appointed hearing officer held a public hearing in Washington, D.C. on October 26, 2007. Two sets of written comments were received prior to the hearing and oral comments were offered by attorneys representing the revenue departments of the states of Georgia and Wisconsin. The hearing officer's report summarizes the proposal's procedural background, key substantive features and public comments. The report recommends adoption of the proposal with some modifications.

II. Procedural Summary

A. Development of the Proposal:

In 2004 the Executive Committee of the Multistate Tax Commission authorized the formation of a special taskforce to study the effects of tax sheltering and to recommend statutory changes to combat sheltering. The increased use of pass-through entities as a means of avoiding tax liabilities became one focus of that group. The income tax uniformity subcommittee of the Uniformity Committee voted in March of 2006 to study the problems associated with the use of Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs) to shelter income from taxation and to develop a model statute to combat such practices. A drafting group was formed[1] and a policy

[1] The drafting group consisted of: Joe Garrett, Alabama Department of Revenue; Carl Joseph, Franchise Tax Board; Reva Tisdale, Idaho Department of Revenue; Leonore Heavey, Louisiana Department of Revenue; Brenda Gilmer, Montana Department of Revenue; Lennie Collins, North Carolina Department of Revenue; Janielle Lipscomb, Oregon Department of Revenue; Kim Ferrell, Utah Department of Revenue; and Tom Shimkin, Counsel with the Multistate Tax Commission.

checklist was developed. At the July 2006 meeting, the Subcommittee voted to limit the statutory drafting efforts to the problems arising from the use of REITs and RICs established with the intent of avoiding state income taxation, rather than addressing some states' broader concerns with the use of pass-through entities generally and their impact on source-based taxation. In November of 2006, the Subcommittee voted unanimously to bifurcate the drafting efforts for RICs and REITs.

Two draft model statutes were presented to the Income Tax Uniformity Subcommittee in San Diego, California in March of 2007. The Subcommittee agreed with the direction taken in those model statutes for RICs and REITs and authorized preparation of a final proposal for the REIT model statute. As a result of further deliberation and development, a draft of a proposed REIT model statute was presented to the Income Tax Uniformity Subcommittee meeting in Minneapolis, Minnesota in July of 2007. As a result of suggestions by some members of the REIT investment community, the Subcommittee voted to amend the draft model statute to broaden the definition of "qualifying" REITs (entities which, although not publicly traded, were still not deemed captive REITs subject to tax) to include foreign investment vehicles which operate similarly to Listed Australian Property Trusts. The proposed draft model statute as amended was approved by the Subcommittee and later submitted to the full Uniformity Committee after further additional minor amendments, where it also received approval.

The Executive Committee considered the proposed draft on August 2, 2007. A motion was made before the executive committee to change the title of the proposal to include the word "captive", to add a new Section A, and to amend section E to eliminate a reference to federal conformity for taxation of REITs other than captive REITs. The significance of these amendments is discussed below. The motion to amend the proposed model statute was carried and the model statute as amended was approved for public hearing.

B. Public Hearing.

After more than 30 days notice to the public and interested parties, a Public Hearing was held on October 26, 2007 in Washington, D.C. Two sets of written comments were received prior to the hearing and oral comments were offered by attorneys representing the revenue departments of the states of Georgia and Wisconsin. The written comments are attached as Exhibits:

Exhibit A: *Comments on Multistate Tax Commission's Proposed Model Statute for Taxation of Captive Real Estate Investment Trusts* from the National Association of Real Estate Investment Trusts (NAREIT).

Exhibit B: *Re: Proposed Model Uniform Statute for Taxation of Captive REITs (Captive REIT Proposal)* from Property Council of Australia

III. Summary of Substantive Provisions

A. Purpose of Proposed Model Statute:

This model statute is intended to prevent the misuse of the Real Estate Investment Trust (REIT) structure as a means to reduce state corporate income and franchise tax liabilities in a manner contrary to the intent and spirit of state tax laws.

Congress created REITs in 1960 to encourage pooled investments in income-producing real estate, such as apartments, hotels, shopping centers, and offices, allowing a wide range of investors access to professional management without entity-level taxation. The statutory system was patterned after special tax treatment afforded to Regulated Investment Companies (RICs) in 1940 which spurred the growth of the mutual fund industry. To ensure that REITs would be used as a vehicle to encourage investment in the real estate market, Congress imposed several restrictions on their structure, including a requirement that REIT ownership must be widely held (shared by at least 100 persons). IRC § 856(a)(5). 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. Any income not distributed by the REIT is subject to tax at the REIT entity level. However, Congress also required that a REIT annually distribute at least 90% of its 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. 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.

Beginning in the 1990's, some corporations saw an opportunity to reduce their state income tax liability by using the REIT structure to isolate operating income beyond the reach of taxing authorities. Closely-controlled REITs have been established by many corporate taxpayers, especially those in the retail and financial industries. Income-producing assets like retail stores and pooled mortgage interests are transferred into the REITs, creating the opportunity to claim a deduction for lease expense and interest expenses to be paid to these REITs, thus reducing the operating companies' reported net income subject to tax. While the great bulk of the REIT ownership is held by a single corporate subsidiary, very small amounts of beneficial ownership are also 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.

The rental or interest income generated by the REIT assets is then paid as a dividend to a subsidiary or affiliate of the taxpayer. These entities are usually established in Nevada or in some other state which does not impose an income tax, and frequently, the dividend is paid to a "captive" insurance company or "offshore" ("80/20") subsidiary that may not be subject to combination in states which impose unitary combined reporting requirements.

The income from the REIT is then ultimately returned to the corporate parent in the form of an ordinary deductible domestic dividend or loan, perhaps after passing through other subsidiaries or affiliates. Thus, the income from these controlled ("captive") REITs is effectively insulated from state taxation. The operating or parent corporation, meanwhile, now enjoys reduced income tax liability because it is able to claim a deduction for rental expense or interest expense paid to the captive REIT. The mechanics of the captive REIT scheme and income flows are described in detail in *Bridges v. Autozone, Inc., 900 So. 2d 784 (2005).*[2]

The captive REIT structure serves to reduce taxes more directly in some states which allowed a deduction for all domestic dividends received and did not distinguish dividends received from REITs and RICs (which are fully subject to federal tax because the dividend-paying entity was allowed a dividends paid deduction.)[3] Because this proposed model statute is limited to the taxation of captive REITs, it should not be seen as a substitute for legislation which may be required to clarify state tax treatment of dividends from pass-through entities generally.

B. Operation of the Model Statute:

The application of the proposed model statute to the problem of captive REITs can be easily summarized. First, the statute identifies its purpose being limited to addressing a specific practice involving use of the captive REIT structure to improperly avoid tax liability. Larger questions of whether the states should continue to adhere to federal practices with respect to shareholder residency-based taxation of income from pass-through entities is recognized as a separate matter for states to consider. Second, the 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. Third, the statute identifies several exceptions to the captive REIT definition for "qualifying" REITs which are not considered as vehicles intended to minimize state taxation. Fourth, the federal dividends-paid deduction for captive REITs is added-back for state purposes. Finally, the model statute describes rules for determining indirect or "constructive" ownership by reference to two federal tax statutes. Some broader considerations about the model statute are discussed in subsection 1-4, below, with a section-by-section summary following in subsection 5:

1. <u>Denial of Dividends-Paid Deduction Permits Entity-Level Taxation.</u>

The proposed model statute combats the tax effects of captive REITs by adding back the federal dividends-paid deduction (DPD) which is otherwise available to the REIT under IRC § 857(b)(2). This has the effect of imposing state income taxes on the bulk of the REIT income at the entity level rather than at the shareholder level, reducing the

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[2] More recently, an article in the Wall Street Journal regarding the creation and operation of a captive REIT allegedly established by that taxpayer has generated considerable interest in state legislatures. Tax experts quoted in the article opined that Wal-Mart may have saved up to $350 million in state taxes in just four years. Wall Street Journal, 2/10/07, page 1.

[3] *See, e.g., Bank Boston Corporation v. Commissioner, 68 Mass. App. 156, 861 N.E. 2 450* (2007), holding that the Massachusetts legislature intended to tax such dividends for periods even prior to the effective date of clarifying legislation..

possibility that income tax can be avoided by establishing a holding company in a tax-free jurisdiction or business structure to receive the taxable dividends. The drafting group and the income tax uniformity subcommittee chose to eliminate the dividends-paid deduction as a relatively simple and efficacious approach to negate the tax benefits of captive REITs. This approach was also chosen because it is the method which has already been adopted by several state legislatures in recent years and would thus foster uniformity among the states.[4] Finally, the methodology was chosen as having the potential for the least disruption of the legitimate investment-oriented REIT industry.

2. Nexus:

Denying the deduction for dividends paid as a method of eliminating the improper tax effects of captive REITs necessarily assumes that the taxing state will have jurisdiction to tax ("nexus") over the REIT. For states which impose income taxes on a separate entity reporting basis, nexus will be limited to captive REITs that own real property in the state. Nexus disputes may also arguably arise where a captive REIT owns indirect real estate interests, such as mortgage pools. For combined filing states, jurisdiction to tax should not be as much of an issue, since a captive REIT will almost certainly be treated as a member of the unitary combined group.[5]

Entity-level taxation as embodied in this proposed model statute will not be effective for separate-entity states where the REIT chooses to eliminate its real property holdings in that state. For instance, if a retailer chooses to transfer ownership of its stores located only in combined filing states to a captive REIT, the retailer would still be entitled to claim a deduction for rent paid to its captive REIT in those states, reducing its pre-apportioned net income as reported to the separate-entity state. The separate entity state would receive no benefit from the imposition of tax on the captive REIT, however, since the REIT has no nexus or apportionment factors in that state.

3. Potential for "Double-Taxation" of Income.

The proposed model statute imposes taxation at the entity level but does not include any mechanism to eliminate the potential for taxing that income again when it is received by a holding company or similar entity. Under IRC § 857(b)(2), corporations are not allowed a dividends-received deduction for dividends paid from a REIT. States which conform to federal dividend treatment and that adopt this proposed model statute arguably run the risk of claims that they are taxing "the same income" twice. States may therefore wish to consider adoption of a dividends-received deduction or tax credit to the extent comparable taxes were paid on the dividends at the entity level.[6]

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[4] Those states include Indiana, Illinois, Kentucky, Louisiana, Mississippi, Maryland, North Carolina, Rhode Island and New York.

[5] New York has gone further and specified that a captive REIT or RIC is required to file returns on a unitary combined basis.

[6] An example of a mechanism for providing a credit for taxes paid can be found in the MTC's Model Statute Requiring Add-Back of Certain Intangible and Interest Expenses, www.mtc.gov, *Adopted Proposals.* That provision could be modified for captive REIT dividends as follows:

As a practical matter, such a provision should be unnecessary because the definition of captive REIT is so narrowly drawn that it should only capture REITs intended to achieve state tax advantages. Those REITs have been designed explicitly so that the recipient is not subject to any state's tax on its dividends. Any concerns over "double-taxation" of income appear for the moment to be more academic than actual. In addition, no true double taxation would occur, even if a state did impose tax on the dividend recipient, because a dividend received by a taxpayer is a separate taxable event from the earning of net income by the REIT paying that dividend. Significantly, none of the captive REIT statutes passed by the states to date provides for any kind of mechanism for elimination of tax on the dividend recipient.

4. Distinctions Between "Captive" and "Qualifying" REITs.

As set forth above, the proposed model statute was written to have the least possible impact on current state taxation policies applicable to the *bona-fide* REIT industry. Thus, the definition of captive REITs and the many exceptions for closely-held REITs which nonetheless would not be subject to tax (so-called "qualifying REITs") were written with that policy consideration in mind. This approach raises two concerns. The first concern is that a taxpayer may be able to circumvent the intent of the statute by reorganizing its captive REIT to meet one of the exceptions to taxation, through, perhaps, multiple tiers of ownership involving non-taxable entities. The second concern is that a closely-held REIT which was not organized for the purposes of minimizing state taxation may find itself subjected to taxation because the list of qualifying REITs was incomplete and is a static compilation as of the time the statute is adopted. One response to these problems would be to provide discretionary authority to tax commissioners to expand or limit the application of the statute in particular circumstances. The drafters of the proposed model statute believed such discretionary authority would create administrative problems and might hamper the overall effectiveness of the statute. The model statute is thus silent as to matters of discretionary or equitable relief, leaving those questions to determination under generally applicable state tax laws and procedures. The hearing officer notes that none of the captive REIT statutes passed to date provides for any sort of discretionary coverage or relief.

5. Discussion and Analysis of Intent of Proposed Model Statute, by Section:

(c) If the [dividend recipient] was subject to tax in this state or another state or possession of the United States or a foreign nation or some combination thereof on a tax base that included the [dividend] paid, accrued or incurred by the taxpayer, the taxpayer shall receive a credit against tax due in this state in an amount equal to the higher of the tax paid by the [dividend recipient] with respect to the portion of its income representing the [dividend] paid, accrued or incurred by the taxpayer, or the tax that would have been paid by the [dividend recipient] with respect to that portion of its income if (1) that portion of its income had not been offset by expenses or losses or (2) the tax liability had not been offset by a credit or credits. The credit so determined shall be multiplied by the apportionment factor of the taxpayer in this state. However, in no case shall the credit exceed the taxpayer's liability in this state attributable to the net income taxed as a result of the [denial of the dividends-paid deduction] required by [Section E] of this statute.

A. Section A provides that the purpose of the statute is to address the problems created by the use of captive REITs. The section is intended to make clear that model statute is not intended as an endorsement, or a rejection, of residency-based taxation for income earned by pass-through entities or other non-taxed entities outside the context of captive or abusive REITs.

B. Section B defines a Real Estate Investment Trusts by reference to federal statutes.

C. Section C defines a captive REIT. It provides that the statute is intended to apply to a REIT which is owned or controlled, directly, indirectly, or constructively, by an entity subject to federal income taxation. Section C(2) is a recognition that some REITs are currently owned by pension funds and other 501(a) organizations which are not subject to federal tax.

D. Section D is a list of entities which may be majority owners of a REIT but whose ownership would not trigger "captive" REIT status. D(1) provides for an exception of REITs owned by other REITs, except for captive REITs. D(2) describes REITs owned by REIT subsidiaries, except for captive REIT subsidiaries. Because of the indirect and constructive ownership rules of C, these provisions should not allow a captive REIT to shield its income through multiple tiers of ownership. D(3) includes listed Australian Property Trusts as entities which may own a controlling interest in a REIT without triggering captive REIT status. Australian Property trusts are widely held and it is believed they could not be used as a mechanism to defeat the intent of the statute to prevent a corporation from creating an artificial deduction for real estate expenses. As set forth in Exhibit B attached hereto, Australian trusts provide a widely-used vehicle for encouraging investment in U.S. real estate without sourced-based taxation. It should be noted that the IRC does impose a 15% withholding tax on distributions to foreign trusts, something no state currently attempts. D(4) is intended to provide a catch-all exception for ownership of U.S. REITs by trusts organized outside the United States which are similar in operation to Listed Australian Property Trusts. Currently several other countries, including Canada, are considering amending their tax laws to recognize pass-through treatment for REIT-like structures which may in turn invest in U.S. REITs. D(4) was drafted to mimic current rules for Listed Australian Trusts and to make it difficult for a U.S. corporation to organize such a foreign REIT for the purpose of avoiding state income taxation.

E. Section E of the proposed model statute provides for the add-back of dividends which are otherwise deductible for captive real estate investment trusts.

F. Section F of the proposed model statute allows an exception to captive REIT treatment for so-called "incubator trusts", which are closely held trusts established for the purposes of demonstrating feasibility of the investment plan prior to the shares being offered to a wider audience. The I.R.C. provides a one-year window for such trusts wherein they are afforded REIT treatment despite being closely held. At the public hearing of this matter, it was suggested that "intended to be regularly traded" exception could provide a loophole for captive REITs based on subjective claims of intent. The hearing officer agrees and proposes an amendment as discussed below to eliminate this potential problem.

G. Section G adopts constructive ownership rules as defined by the IRC.

IV. Summary of Written and Oral Comments and Recommendations.

1. The National Association of Real Estate Trusts (NAREIT) submitted written comments (Exhibit A) generally supporting the proposed model statute but suggesting the best approach would be to continue to conform to federal treatment of all REITs. The comments from NAREIT include a detailed description of many closely-held REITs which have legitimate (non-state-tax motivated) business purposes. NAREIT mentions the possibility of double-taxation if states were to deny the DPD while continuing to follow the federal treatment of REIT dividends. For the reasons previously-discussed, the hearing officer believes that the current proposal's limited impact to captive REITs effectively precludes a realistic possibility of double taxation. The hearing officer cannot agree with the suggestion that the states should not act to address the captive REIT problem through statute, and believes that this statute is the least burdensome method to protect state interests.

2. The Property Council of Australia ("the Council") submitted written comments generally supportive of the proposal but suggesting two substantive changes. (Exhibit B). First, the Council suggests an amendment to D(4) of the proposed statute, a subsection which was intended as a catch-all provision to allow qualified ownership treatment for entities like Listed Australian Property Trusts (LAPTs) but which are not themselves LAPTs. The Council suggests that some Australian Trusts functional like LAPTs but are not themselves listed, and thus need to rely on D(4). Subsection D(4)(b) provides that an entity must receive a dividends-paid deduction comparable to Section 561 of the IRC. The Council points out that Australian Property Trusts are not subject to tax on distributed earnings, but the tax treatment is not in the nature of a DPD. In addition, the Council notes that Australian Property Trusts are not required to distribute their earnings, although failure to do so would result in taxation at the highest marginal rates.

The hearing officer recommends an amendment to Section D(4)(b) and (4)(c) to meet the Council's concerns. First, the hearing officer recommends striking the current language in the subsection and to provide instead:

"(b) the entity is not subject to tax on amounts distributed to its beneficial owners, or is exempt from entity level taxation;"

The hearing officer recommends an amendment to Subsection d(4)(c) to read:

"(c) the entity [is required to distribute] <u>distributes</u> at least 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;"

The Council also urges an amendment to accommodate widely held "Wholesale Property Trusts" which apparently operate in a manner similar to LAPTs but are not themselves listed on a public exchange. The Council urges an amendment to Subsection D(4)(d) to the statute to provide that "widely held" would include ownership by seven different categories of closely held entities, including an entity whose shares are regularly traded on an established securities market. The hearing officer has a concern that such an amendment may be inconsistent with the intent to the statute. Almost all large corporations trade their shares on established securities markets. Although it may be far-fetched, it seems remotely possible that a corporation subject to state taxation could hold ownership in a captive REIT through a Wholesale Property Trust and still obtain a state tax benefit. It is more likely that such an arrangement would result in additional federal withholding tax. The hearing officer has asked the Council to expand upon its statement and to provide alternative language to accomplish its goals. The hearing officer cannot recommend this change at the present time.

3. An attorney from the Wisconsin Department of Revenue expressed concern that the "incubator trust" provisions of Section F could be abused by captive REITs. In theory, a corporation could transfer its assets on an annual basis from one "incubator trust" to another, always with the purported intent of someday becoming widely held. The hearing officer believes that this scenario, while seemingly unlikely, cannot be ruled out entirely, and so recommends addition of language which would retroactively impose liability on an incubator REIT which did not become regularly traded and which meets the other conditions of being a captive REIT. That language was included in earlier drafts of the proposed model statute:

> A real estate investment trust that does not become publicly 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 publicly traded on an established securities market, retroactive to the date it first became a real estate investment trust, and shall file an amended return reflecting such retroactive designation for any tax year or part year occurring during its initial year of status as a real estate investment trust. For purposes of this section, a real estate investment trust becomes a real estate investment trust on the first day that it has both met the requirements of IRC §856 and has elected to be treated as a real estate investment trust pursuant to IRC § 856(c)(1).

IV. Additional Recommendation for Separate Filing States.

Because the model statute as currently proposed may not be effective with respect to captive REITs which are not subject to a separate entity's state's taxing jurisdiction, the hearing officer recommends that states consider amending their current add-back statutes to explicitly include the add-back of rents and interest expenses paid to a captive REIT.

Respectfully submitted,

Bruce J. Fort
Hearing Officer