NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 12, 2011

Loretta King
Multistate Tax Commission
444 N. Capitol Street, N.W., Suite 425
Washington, D.C. 20001-1538
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Re: Comments on Multistate Tax Commission's Proposed Model Statute Regarding Partnership or Pass-Through Entity Income That is Not Subject to Income Tax

Dear Ms. King:

The National Association of Real Estate Investment Trusts (NAREIT)® thanks you for the opportunity to submit comments on the Multistate Tax Commission's (MTC) draft Proposed Model Statute Regarding Partnership or Pass-Through Entity Income That is Not Subject to Income Tax, which is posted on www.mtc.gov (2011 Proposed Draft). Similarly to our comments with respect to the MTC's model captive REIT statute first adopted in 2008, and as further set forth below, NAREIT recommends that the 2011 Proposed Draft be modified so that it achieves its goal of preventing inequitable treatment among taxpayers without modifying the existing state tax treatment of widely-held REITs.

NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

EXECUTIVE SUMMARY

NAREIT appreciated the opportunity to participate in the MTC's development of a model captive REIT statute. In connection with that process, NAREIT submitted comments to the MTC in October 2007 indicating our support of its final draft (Final Draft) of the model captive REIT statute. In general, that model statute provides that a REIT's dividends paid deduction (DPD) should be added back for state corporate income tax purposes by a REIT that is a captive REIT. [1]

[1] As you know, the model captive REIT statute that the MTC originally adopted was proposed to be modified from solely requiring that a captive REIT add back its dividends paid deduction to also requiring a related party to a captive REIT to add back certain expenses paid to the captive REIT.

A "captive REIT" is defined as a REIT, that is not: a) a publicly traded REIT and of which b) more than 50% of the voting power or value of beneficial interests or shares are directly or indirectly owned or controlled by a single taxable entity that is treated as an association taxable as a corporation under the Internal Revenue Code of 1986, as amended (the Code). The Final Draft then excludes from the definition of entities treated as associations taxable as corporations: REITs, qualified REIT subsidiaries (QRSs); "listed Australian property trusts," as specifically defined (LAPTs) (Australia's version of the U.S. REIT) and/or trusts 75% or more held by an LAPT; and certain non-listed and listed foreign REIT-like entities.

NAREIT supported the Final Draft of the MTC's model captive REIT statute in 2007 because it specifically addressed the MTC's concern with respect to "captive REITs" without affecting the DPD of widely-held and/or publicly traded REITs. NAREIT continues to believe that the most appropriate model for state taxation of REITs and their shareholders is conformity with federal principles (as is the case for publicly traded REITs in virtually every state with an income-based tax system). Under this model, the REIT is subject to tax, but a state permits a (non-captive) REIT a DPD while taxing its residents on REIT dividends regardless of where the income giving rise to those dividends was generated.

Similarly, with respect to the 2011 Proposed Draft, while NAREIT understands the MTC's objective in avoiding inequitable treatment among taxpayers, it appears that the Proposed Draft overreaches by inadvertently imposing tax on certain non-public REITs implicitly recognized as legitimate and non-abusive by the MTC in connection with its model captive REIT statute as well as potentially certain REIT-owned partnerships –structures used by the vast majority of real estate owners in the U.S. Accordingly, we recommend that the 2011 Proposed Draft be modified so that its effect is limited to its original objective. We specifically oppose any attempt to impose an income tax on partnerships, disregarded entities, or other pass-through entities, which for decades have been the method of investing in real estate by both REITs and non-REITs. Instead, we recommend that the MTC tailor this statute so that it achieves its objective without inadvertently imposing tax on legitimate and non-abusive business structures.

Set forth below is background concerning the REIT structure and more details concerning our comments.

DISCUSSION

I. Background

A. REITs Are Not "Tax Shelters," But Were Designed to Benefit the "Small Investor"

Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through professionally managed companies. REITs combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, hotels, shopping centers, offices, timberlands, and warehouses. REITs must be taxable as domestic corporations and are required to distribute at least 90% of their taxable income to their shareholders. In exchange for doing so (and for satisfying a number of other requirements that ensures their business is real estate focused)[2], federal law grants REITs (and mutual funds) a DPD**.** Thus, REITs are subject to tax and, to the extent that REITs retain taxable income, they must pay corporate income tax. Accordingly, REITs are not pass-through entities like partnerships and limited liability companies. REITs distribute dividends to shareholders, and may not pass through credits or losses. In 2010, listed REITs distributed more than $18 billion to their shareholders.

As further described below, REITs own their properties in a variety of different formats – directly, through REIT-specific disregarded QRSs, through lower-tier partnerships/limited liability entities or disregarded entities, as well as through lower-tier REITs.

B. REITs Benefit Investors and the Economy

Congress' vision has been realized: as of March 2011, more than 150 publicly traded REITs had a total equity market capitalization of more than $400 billion. Throughout the U.S., real estate owned by REITs generates millions of dollars in property taxes on top of the individual income taxes currently generated by REIT dividends paid to state residents. Investors have benefited from owning REITs: the 15-year compound annual return for the period ending March 31, 2011 of the S&P 500 stock index was 6.80 %, while that of REITs was 10.20 %**.**

Since 2008, listed REITs have raised about $100 billion in equity and debt to strengthen their balance sheets, and, therefore, help to stabilize the commercial real estate economy and financial institutions. By doing so, these REITs helped to limit the collapse of commercial real estate values, thereby helping to restore the critical property tax base of state and local governments.

The economy benefits from REITs as well – because REITs cannot pass through losses to investors (unlike partnerships), their focus must be on creating value for shareholders. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public REITs are less than 50%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Simply put, REITs are the most practical method for investors to add commercial real estate in their investment portfolios to obtain the asset diversification recommended by most financial advisors.

C. Most States Tax REIT Income Only Once at the Shareholder Level

Virtually all states with income-based taxes follow the federal rules and do not levy direct income taxes on REIT income or REIT-owned partnerships except to the extent that the REIT retains income or capital gains. These states tax REIT dividends received by the residents of their state (regardless of whether the REITs, from which these residents received dividends, own

[2] Non-REIT C corporations generally have no similar limitation on their business activities or distribution policies; they are free to retain capital as needed. REITs, on the other hand, must continuously return to the capital markets to raise equity or debt in order to make additional investments. As a result, REITs, particularly SEC-registered REITs, must maintain a significant level of transparency and business success in order to be able to raise capital on a going-forward basis.

properties in such state), and collect a great deal of state and local property taxes from the real estate investments that REITs must make to maintain their status.

Nearly every state with an income-based system follows the federal rules and allows the DPD. Only Mississippi limits its DPD to "publicly traded" REITs, a term that is not defined. In 2007, Maryland enacted a law that permits the DPD to reduce Maryland taxable income only for a REIT that is either: (i) publicly traded; or (ii) not more than 50% held by a taxable corporation that is not a REIT or an LAPT. Also in 2007, Kentucky and Indiana adopted statutes that are conceptually similar to the Maryland statute (although the triggering threshold in Kentucky is lower than in the other states). Louisiana adopted a similar statute in 2005. Since then, a number of additional states have adopted "captive REIT" statutes in which the state denies the DPD for a REIT generally more than 50% held by a taxable C corporation (other than a REIT, QRS, and, in some states, a foreign, REIT-like entity). In 2008, the MTC adopted a similarly phrased captive REIT statute. More recently, the MTC has worked on using a similar definition of captive REIT but requiring a related party add-back, rather than a DPD disallowance (for cases in which the relevant state did not have nexus over the REIT).

The above-mentioned statutes prevent or would prevent a REIT from being used primarily to escape state income taxes, while not disturbing the economic activities of widely-held REITs.

D. REIT Investment Structures

Set forth below is a list of the various structures in which REITs invest in real estate assets.

1. Operating Partnerships Owned by Umbrella Partnership REITs (UPREITs)

The limited partnership is and has been for decades the prevalent form for owning real estate in the U.S. – both for REITs and non-REITs. Of the more than 150 publicly traded REITs, about 50% own property through a limited partnership structure called an "umbrella partnership REIT" or "UPREIT." An UPREIT is a legitimate business form used nationwide to comply with certain federal income tax rules. The Internal Revenue Service has endorsed UPREITs, and does not consider them abusive.

a. <u>What is an "UPREIT"?</u>

An UPREIT generally consists of a publicly traded REIT that owns substantially all of its assets and conducts substantially all of its operations through an operating partnership or "OP." As a rule, the REIT will own a number of "common units" in the OP equal to the number of shares of common stock that the REIT has outstanding. In addition, if the REIT has preferred stock outstanding, the REIT will own "preferred units" in the OP that correspond to the shares of preferred stock that the REIT has outstanding.

b. Why an "UPREIT"?

The UPREIT structure was developed to facilitate the desire of real estate owners to be able to access the public capital markets through the flow-through structure commonly used in the real estate industry while deferring the immediate recognition of taxable gain that would result it they were to transfer their properties or property-owning partnership interests directly to the REIT in exchange for REIT shares, rather than to the OP in exchange for units.

Under section 351(e) of the Code, a transfer of property to a REIT in exchange for REIT shares in connection with the formation of the REIT and an IPO by the REIT often will result in the recognition of gain for tax purposes, even though most business owners who transfer their businesses to a corporation in connection with an IPO would not recognize gain. This tax gain can be deferred if the property owner instead receives OP units, rather than REIT shares. The IRS has indicated that it does not consider the UPREIT structure abusive. *See*, *e.g*., Example 4 of Treas. Reg. § 1.701-2 (the partnership anti-abuse regulations). Since much of the real estate industry holds real estate in partnership form, the use of an UPREIT structure does not represent a significant departure from that of the structures used by non-REIT real estate investors.

c. Liquidity in an UPREIT: Redemption/Exchange Right

In the typical UPREIT structure, the holder of OP units generally will have the right to require the REIT or the OP to redeem all or some of its units for an amount of cash equal to the agreed upon "value" of those units. Under the typical partnership agreement for an UPREIT, the "value" of a unit is defined as equal to the value of a common share of stock of the REIT so long as the stock of the REIT is publicly traded.[3]

2. Non-OP Partnerships, Limited Liability Companies, and Disregarded Entities

REITs also invest in properties through partnerships and limited liability companies (LLCs) that are not OPs, as well as through LLCs that are disregarded entities or QRS (which the REIT rules treat as a disregarded entity pursuant to section 856(i) of the Code).

3. Lower-Tier REITs Owned by REITs or OPs

As we noted in our October 2007 submission to the MTC concerning its proposed model draft statute concerning "captive REITs," although there had been a great deal of press recently concerning the use of private REITs as a "state tax shelter," many widely-held REITs and LAPTs hold their properties through lower-tier REITs. In certain cases, a publicly traded REIT that acquires another publicly traded or widely-held REIT will keep the acquired company as a private REIT subsidiary for goodwill purposes or to avoid the need to obtain lender consents. Similarly, LAPTs often own U.S. REIT shares directly to facilitate compliance with the U.S.-

[3] Because the REIT generally does not own significant assets other than its interest in the OP, and because it owns a number of OP units equal to the number of common shares that it has outstanding, the value of a share of the common stock is in fact the best approximation of the value of an OP unit.

Australian Tax Treaty by their small unitholders. Additionally, tax-exempt institutions and/or LAPTs may invest, along with one or more publicly traded REITs, in a joint venture entity formed as a privately held REIT.

Finally, just as lower-tier REITs may be owned by parent REITs, so too may they be owned by REIT-owned OPs.

4. Direct Ownership

In certain circumstances, REITs (particularly lower-tier REITs of parent REITs or OPs) may own properties directly.

II. Comments

A. Summary of 2011 Proposed Draft: Generally

The 2011 Proposed Draft provides as follows:

> 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.

As we understand from the 2011 Proposed Draft, any partnership, REIT, QRS, limited liability company (LLC), etc. (the Sub) more than 50% owned by another partnership, REIT, QRS, LLCs, etc. (the Parent) would be subject to state-level entity tax if the Parent were not "subject to income tax." The term "subject to income tax" is not defined. As described above, REITs are subjects to income tax, but the proposal to treat a REIT as a partnership raises concerns in this regard. The accompanying memorandum by Mr. Sheldon H. Laskin to the 2011 Proposed Draft indicates that the purpose of the draft is to address perceived inequities among taxpayers – particularly relating to the ownership of pass-through entities by insurance companies which are generally exempt from state income taxation. However, the 2011 Proposed Draft appears to go this stated purpose.

Among other things, the provisions of the 2011 Proposed Draft could impose an entity-level tax on one or more of the following types of legitimate REIT structures: a) a widely-held REIT's non-public REIT subsidiary; b) a widely-held REIT's OP; c) the non-public REIT subsidiary of a widely-held REIT's OP; or d) a widely-held REIT's QRS if, in all cases, the parent entity is not "subject to income tax." We note that these results do not seem equitable, particularly since a REIT could invest directly in the properties owned by these disregarded or pass-through entities without such an entity-level tax (other than to the extent the REIT retained income or failed to qualify as a REIT), and there is no reason to impose an entity-level tax on the pass-through or disregarded entities owned by the REIT.

B. The 2011 Proposed Draft Should Be Narrowed So It Does Not Affect Legitimate Business Transactions

First, we strongly oppose any attempt by the state and local government to deviate from the long-standing federal treatment of partnerships as being not subject to a direct income tax. On the other hand, we recognize the MTC's concerns and whole heartedly agree that the MTC should craft a solution to the perceived inequity among taxpayers limited to that inequity.

Second, we believe that the most appropriate method of taxation for REITs and their shareholders in states with income tax regimes is to conform to the federal model of taxation. As noted above, virtually every state with an income-based tax structure allows publicly traded REITs the DPD. Additionally, these states then tax all REIT dividend income received by resident shareholders, regardless of where the REIT's real estate is located.

For example, State A imposes an income tax on all of the REIT dividends earned by a State A resident shareholder of a REIT with only State B properties, while, at the same time, State B imposes its income tax on all of the REIT dividends earned by a State B resident of a REIT with only State A properties. In that example, neither state may collect income taxes on the REIT based on the location of in-state property if the REIT rules are followed, and income distributed to investors. If State A were to seek to impose an additional REIT-level tax on a REIT with State A properties (which could be owned more than 50% by another REIT, partnership, or LLC), that would result in double taxation of that REIT's income and inappropriate revenues to State A, making State A's tax policy out of sync with the rest of the nation.

With that said, we recognize a state's interest in adopting legislation that would limit any inappropriate use of REITs, including the "captive REIT" structures that were publicized over the past few years, and for which the DPD in certain cases involving certain non public REITs has now been denied, as the MTC has recommended through its model captive REIT statute. However, subsequent legislation that is intended to mitigate the state tax impact of other transactions involving REITs should be narrowly tailored to apply only to those transactions that were within the stated objective of the proposal and not inadvertently disturb the legitimate uses of business transactions involving REITs that have enabled small investors to participate in the growth of a dynamic real estate market for the past 50 years.

At a minimum, we recommend that the 2011 Proposed Draft be narrowed to categorically exclude a REIT from the definition of a “partnership or disregarded entity.” As described above, a REIT is in fact a taxable entity – it is simply and mechanically a beneficiary of the DPD as long as it continues to satisfy the rigorous conditions for investing only in real property assets and by distributing nearly all of its income to its shareholders such that such income can be subject to a single-layer of tax at the shareholder level. Furthermore, we would not support the inclusion of even a captive REIT in the definition of “partnership or disregarded entity” for fear that it would interfere with and confuse the carefully designed rules the MTC and the various states have already addressed in their model captive REIT statutes. Finally, we believe that, the 2011 Proposed Draft should be modified so that it would not impose entity-level tax on OPs, LLCs or QRSs owned by widely-held REITs.

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Thank you again for the opportunity to submit these comments. Please contact me at (202) 739-9446, or my colleague Tony Edwards, at (202) 739-9408 if you would like to discuss these comments in more detail. I plan to attend the May 16, 2011 MTC Uniformity Committee meeting. I will be available to discuss these comments in more detail there as well.

Sincerely,

Dara F. Bernstein

Dara F. Bernstein
Senior Tax Counsel

Cc: Sheldon H. Laskin, Esq. (slaskin@mtc.gov)