IN THE OFFICE OF HEARINGS AND APPEALS
OF THE DEPARTMENT OF FINANCE AND ADMINISTRATION
OF THE STATE OF ARKANSAS

IN THE MATTER OF:	)	
	)	**DOCKET NO.**
PROPOSED CORPORATE	)	
INCOME TAX ASSESSMENT	)	
ACCOUNT NO.	)	

TAXPAYER'S PREHEARING MEMORANDUM

Background: is a real estate investment trust ("REIT") subject to the provisions of Subchapter M of the Internal Revenue Code. More particularly, it is the type of REIT commonly known as an "umbrella partnership real estate investment trust" or "UPREIT." Ownership interests in are regularly traded on the New York Stock Exchange.

A leading reference source provides the following commentary concerning UPREITs:

> An umbrella partnership real estate investment trust (UPREIT) is a REIT that holds all or substantially all of its properties through a partnership (typically called the "operating partnership") in which the REIT holds an interest. UPREITs were first used in the early 1990's by real estate owners seeking an alternative source of financing. The UPREIT was designed to give real estate owners access to public capital markets, while permitting them to defer their built-in gain, which would be recognized if they directly contributed their properties to a REIT.

TM Portfolio 472-3rd, V.A. (2008). *See,* excerpt attached as Exhibit A. By 1994, approximately 75% of initial public offerings of REITs used the UPREIT structure, and this trend has continued since that time. *Real Estate Investment Trusts Handbook*, §1:15 (2011-2012 Edition).

In case, virtually 100% of its real estate investments are held through the operating partnership. During 2010, the operating partnership held an interest in investment property located in Arkansas.

Subchapter M of the Internal Revenue Code (expressly adopted by Arkansas, *see* page 4, *infra*) specifically provides that REITs may deduct dividends paid to shareholders in determining taxable income. Subchapter M. §857(b)(2)(B) provides as follows:

> §857 Taxation of real estate investment trusts and their beneficiaries. ...
> (b) Method of taxation of real estate investment trusts and holders of shares or certificates of beneficial interest. ...
> (2) Real estate investment trust taxable income. ...
> (B) The deduction for dividends paid (as defined in section 561) *shall be allowed.* ...
> (Emphasis supplied.)

See complete text of IRC §857(b)(2)(B) attached as Exhibit B.

For federal tax purposes, REITs deduct net operating losses and dividends paid in the same manner and on the same line on the prescribed reporting form. *See* Federal Form 1120-REIT (2010) (p. 1) attached as Exhibit C, lines 21 a. and b. Arkansas does not have a special reporting form for REITs and no line is designated for the dividends paid deduction either on generic Form AR1100CT or on generic Schedule A- Apportionment of Income for Multistate Corporations. Accordingly, filed Form 2010 AR1100CT and Schedule A with a footnote claiming its dividends paid deduction.[1] *See* Form 2010 AR1100CT attached as Exhibit D. Upon review, the deduction was disallowed.

Audit Position. The rationale for the Department's audit position is not entirely clear. There is no dispute that multistate corporations are required to use Schedule A to compute

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[1] "ARKANSAS FOOTNOTES
ALLOCATED INCOME FROM
LESS: DIVIDEND PAID DEDUCTION

income apportioned from multistate operations and to allocate certain types of income, including partnership income, directly to the state.

The Department's Answers to Information Request filed May 21, 2012, indicate that the Department's position is based entirely on the proposition that "Partnership income is not apportionable." There is no dispute concerning this statement. In fact, clearly reported its partnership income as "allocated income." See footnote 1 above and Exhibit D.

The Department's Answers also point out that Corporate Income Tax Rule §1.26-51-802(b) directs that partnership income be moved from Schedule A, Part A to Schedule A, Part C, "Direct Income Allocated to Arkansas." There is no dispute concerning this statement either, and this is consistent with reporting in the footnote to its Arkansas return.

The Department's Answers then jump to the following conclusion: "The deduction would be applicable to apportioned income of the REIT. It cannot be applied to the REIT's allocated partnership income." The Department's Answers cite no authority for this position, which seems to be founded entirely on the fact that generic Arkansas Schedule A has not been modified to provide a special line to deduct dividends paid from income that is allocated in Part C rather than apportioned in Part A.

Taxpayer's Position. The Department's audit position is contrary to statutory law, contrary to Department precedent, contrary to Arkansas' Supreme Court opinions and a final assessment based on such a position would be unconstitutional as it discriminates against multistate REITs.

Schedule A itself undermines the Department's logic. Note that Part C line 3 specifically provides a line to deduct "Apportioned NOL to Arkansas" from allocated income, including

partnership income. The net operating loss deduction is provided in Ark. Code Ann. §26-51-427, Deductions-Net Operating Loss Carryover, and provides as follows:

> *In addition to other deductions allowed by this chapter* there *shall also be allowed* as a deduction from gross income a net operating loss deduction ... (Emphasis supplied.)

There are no specific provisions in Arkansas law or regulations that address *how* to take an NOL deduction against allocated income of a multistate corporation, but Schedule A still permits taxpayers to claim NOL carry-forwards as a deduction from allocated income in computing total income taxable to Arkansas.

Similarly, Ark. Code Ann. §26-51-440(a)(1) provides as follows:

> Subchapter M of the Internal Revenue Code of 1986 as in effect January 1, 2011 relating to . . . real estate investment trusts . . . is adopted for the purpose of computing Arkansas income tax liability ...

Under Subchapter M, a deduction for dividends paid "shall be allowed." IRC §857(b)(2)(B). The NOL deduction and the dividends paid deduction for REITs have equal standing under Arkansas law.

The Arkansas Supreme Court has directed that tax statutes must be read "*in pari materia*" and has provided the following direction to the Department: "Additionally, statutes relating to the same subject are said to be *in pari materia* and should be read in a harmonious manner if possible." *Weiss v. Maples*, 369 Ark. 282, 287, 253 S.W.3d 907, 912 (2007). *See also, Arkansas Department of Economic Development v. William J. Clinton Presidential Foundation*, 364 Ark. 40, 216 S.W.3d 119 (2005); *Morris v. Arkansas Department of Finance and Administration*, 82 Ark. App. 124, 112 S.W. 3d 378 (2003).

The provisions concerning the allocation of partnership income must be read and applied in a manner that is harmonious with the dividends paid deduction granted to REITs in Subchapter M. The Department's position would disregard Subchapter M in its entirety.

Finally, any interpretation that a REIT cannot deduct dividends paid simply because it has multistate operations would be unconstitutional. Under the Department's present interpretation, an UPREIT that invests entirely in partnerships that own Arkansas real estate would be granted the full dividends paid deduction. All income would be reported on Form AR1100CT and dividends paid would be deducted on line 28 "Other deductions" in their entirety.

By contrast, under the Department's position, an UPREIT that has income from even one out-of-state partnership investment is permitted no dividends paid deduction, based strictly on the organization of Schedule A. Such an interpretation would facially discriminate against REITs with multi-state operations in clear violation of the Commerce Clause. USCA Const. Article 1, §8.

The leading treatise discussing the constitutional restrictions on state taxing power summarizes the Commerce Clause limitations in clear terms:

> The rule prohibiting state taxes discriminating against interstate commerce has been a fundamental tenet of the Court's Commerce Clause jurisprudence from the very beginning. Although the concept of discrimination is not self-defining and the Court has never precisely delineated the scope of the doctrine forbidding discriminatory taxes, the central meaning of discrimination as a criterion for adjudicating the constitutionality of state taxes on interstate business emerges unmistakably from the Court's numerous decisions addressing the issue: *A tax that by its terms or operation imposes greater burdens on out-of-state goods, activities, or enterprises than on competing in-state goods, activities, or enterprises will be struck down as discriminatory under the Commerce Clause.* Perhaps the Court came closest to capturing the "core" of its jurisprudence in this context when it observed that Commerce Clause discrimination "simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter. (Emphasis supplied.)

Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* ¶4.14 (Third Edition 2001-2012)

Prof. Hellerstein goes on to state the following:

> State taxes that discriminate in practical effect against interstate commerce are as offensive to the Commerce Clause as are taxes that explicitly discriminate against such commerce. The Court has consequently made it clear that the Commerce Clause bars taxes effectively discriminating against interstate commerce no less than taxes that do so by their terms. "The Commerce Clause," the Court has observed, "forbids discrimination whether forthright or ingenious." Accordingly, the Court has stated that "[i]n each case it is our duty to determine whether the statute under attack . . . will in its practical operation work discrimination against interstate commerce."

Id. at ¶4.14[1][b].

There can be no clearer discrimination in practical effect than for Arkansas to deny the dividends paid deduction in its entirety if a partnership has even one out-of-state investment.

Conclusion. Until such time as Arkansas decides to issue a special Form AR1100CT and Schedule A for REITs and other corporations that are subject to the special provisions of Subchapter M of the Internal Revenue Code, deducting dividends paid by footnote or addendum to the form is appropriate. There is no basis for the Department's overly restrictive position in this case.

Respectfully submitted,

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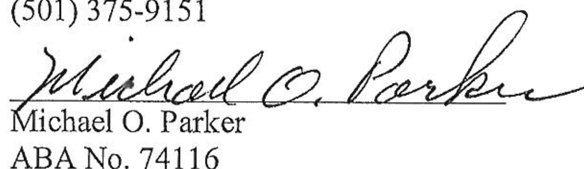

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