March 7, 2003

NAREIT State & Local Tax Policy

Bulletin

National Association of Real Estate Investment Trusts®

This is the first issue of NAREIT's State and Local Tax (SALT) Policy Bulletin for 2003. With states facing significant budget shortfalls this year, we need to be especially attentive in evaluating state legislative developments that may affect REITs. We summarize several relevant developments below. Please continue to keep us informed of developments, and we will continue to share this information with our members. Many thanks to Jane Steinmetz and Jon Muroff of PricewaterhouseCoopers LLC and Michele Randall of Deloitte & Touche LLP for assisting with this SALT Bulletin.

HIGHLIGHTS

Kentucky Governor Proposes Scrapping Corporate Tax For Business Activity Tax on All Limited Liability Entities

On February 5, 2003, Kentucky's Governor, Paul Patton (D) explained his tax plan of eliminating the current corporate income tax in favor of a "business activity tax" imposed on any taxpayer's payroll and sales in Kentucky. http://gov.state.ky.us/2003budget/2003budgetaddress.htm for the Governor's address and http://gov.state.ky.us/2003budget/kyfuture.pdf for more details. Note that neither document addresses REITs specifically. The tax would apply to most limited liability businesses operating in Kentucky, including corporations, business trusts, limited partnerships, and limited liability companies ("LLCs"), but would exclude professional limited liability partnerships and professional LLCs (e.g., doctors, lawyers, accountants), banks and insurance companies. Because both business trust and corporate REITs enjoy limited liability, presumably both entities would be subject to this new tax. The rate for payroll would be $0.60/$100, and the rate for sales would be $0.13/$100. Individual owners of limited partnerships, LLCs, and S corporations would receive a credit equal to their proportional share of the business activity tax paid by the pass-through entity.

Apparently, there is little legislative support for the Governor's proposal, and no legislation has been submitted for this proposal. Further, our understanding is that it would be too late to

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submit any legislation for the current legislative session. While there have been discussions of holding a special legislative session, currently none is scheduled. Nevertheless, this proposal is important because it would represent a significant departure from Kentucky's current taxing regime.

Maryland Once Again Proposes Taxing Transfers of Controlling Interests in Real Property Entities

Many of you may remember that last year, as it faced a significant budget shortfall, Maryland considered legislation (S.B. 316 and H.B. 557) that would have imposed Maryland's recordation and transfer tax on transfers of "controlling interests" in entities whose assets consisted primarily of real estate. Thanks in part to the many letters sent by some of NAREIT's corporate members to key Maryland policymakers, this legislation was not enacted. In addition, Pat Hughes of Mid-Atlantic Realty Trust and Dara Bernstein of NAREIT both testified in Annapolis in opposition to the legislation.

F. Patrick Hughes, President
Mid Atlantic Relaty Trust

Like many states, Maryland again is facing a budget deficit, and similar transfer tax legislation has been proposed in Maryland this year as S.B. 120, (http://mlis.state.md.us/2003rs/billfile/sb0120.htm) and H.B. 19, (http://mlis.state.md.us/2003rs/billfile/hb0019.htm). These bills would tax the transfer of a "controlling interest" in a "real property entity." While not entirely clear, the legislation appears to apply to tiered structures. Therefore, the merger of a publicly traded REIT, which, through several entities, owned an entity that owned Maryland property, could trigger imposition of the tax. Many members responded to NAREIT's request to send letters of opposition to key Maryland policymakers prior to the Maryland Senate Budget and Taxation Committee's hearing on this bill on February 5, 2003. (For those members who have not done so, it still would be useful to send in your letters of opposition.) Pat Hughes of Mid-Atlantic Realty Trust again testified at this hearing, and NAREIT again submitted written testimony. NAREIT will continue to monitor this legislation.

Missouri Case Allows Partner to Measure Franchise Tax Base By Net Value of Partnership Assets

The statutory definition of the Missouri franchise tax base is "the par value of the corporation's outstanding shares and surplus." According to the administrative rules, the term "surplus" is defined as total assets without regard to liabilities. In practice, the franchise tax base is the greater of a corporation's surplus or the par value of its outstanding shares. There is no Missouri case law addressing how to measure the value of an interest in a partnership for purposes of the franchise tax.

For REITs that invest in Missouri real estate through partnerships or LLCs taxed as partnerships, whether the franchise tax base is measured according to the gross value of the partnership's assets or the net value of assets (assets minus liabilities) has not been clear. The Missouri Department of Revenue ("Department") has been attempting to assess franchise tax on audit by including the proportionate share of a corporate partner's gross value of partnership assets instead of the net value of assets in the franchise tax base.

Recently, in Saint Luke's Health Ventures Inc. v. Director of Revenue, Missouri Administrative Hearing Comm'n, No. 02-0339 RV, November 13, 2002, See www.oa.state.mo.us/ahc/case/StLukesHealthVenturesInc02-0339RV.KAW.doc, the Missouri Administrative Commission held that a limited partner should be permitted to report on a "net" versus "gross" assets basis.

St. Luke's is currently under appeal and regardless of this recent ruling, the Department informally commented that it will continue to assess franchise tax for corporate partners by using the gross assets from their interest in partnerships.

New Jersey: Dividend Paid Deduction Preserved but Alternative Minimum Assessment Enacted

As you may know, the state of New Jersey last year considered legislation that would have repealed the dividends paid deduction ("DPD") for REITs. NAREIT organized a coalition of concerned REITs to fight this legislation that was successful in doing so. However, facing a huge budget deficit, New Jersey did enact a new tax, called the "alternative minimum assessment" or "AMA." Additionally, the legislation assessed a $150 per-partner fee on all partnerships with income from New Jersey sources.

The AMA applies for tax years starting on or after January 1, 2002. Under the AMA, corporate taxpayers are subject to a "franchise tax" on the greater of: (1) their normally computed corporate business tax ("CBT") liability, computed based on the taxpayer's apportioned "entire net income," or (2) the AMA, which is computed as a percentage of either gross receipts or gross profits. Most REITs pay little CBT due to the dividends paid deduction, but the AMA is applied based on gross receipts or gross profits, with no reduction for dividends paid. Representatives from the New Jersey Division of Taxation have stated publicly that the AMA applies to REITs, and that the DOT intends to interpret the AMA in the most far-reaching way possible.

On February 21, 2003, the New Jersey Division of Taxation released proposed rules under its July 2002 legislation. The proposals are posted on the New Jersey Division of Taxation's website, at www.state.nj.us/treasury/taxation/pdf/cbtreform.pdf. While time did not permit an exhaustive review of the regulations' 129 pages, it appears that the regulations did not address the application of the AMA to REITs or its application to corporate partners. The regulations do appear to adopt an apportionment methodology to address the liability of partnerships for the $150 per-partner fee in cases when the partnership has a very remote physical connection to New Jersey.

New Jersey once again is facing a large projected deficit, but Governor McGreevey's (D) proposed budget did not suggest disallowing the DPD. NAREIT appreciates the efforts of executives from Boston Properties, Inc., Brandywine Realty Trust, Kramont Realty Trust, Liberty Properties Trust, and Vornado Realty Trust, who participated in a presentation redevelopment authorities made recently about potential investment opportunities in Camden, New Jersey, as well as efforts by executives of those companies, Pennsylvania REIT, and The Rouse Company, who met with two New Jersey policymakers several weeks ago, as a means of demonstrating continuing REIT interest in New Jersey investment opportunities.

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North Carolina Changes Franchise Tax Treatment of Corporate Members of LLCs

In 2001, the North Carolina legislature enacted legislation intended to restrict North Carolina franchise tax planning using limited liability companies ("LLCs"). On October 1, 2002, Governor Easley signed into law S.B. 1115, http://www.ncga.state.nc.us/html2001/bills/AllVersions/Senate/S1115vc.html, which amends the 2001 legislation in an effort to limit further a corporate member's ability to use LLCs to reduce North Carolina franchise tax. This amendment may negatively affect a REIT that, independent of its interest in lower tier LLCs or QRSs, is subject to North Carolina tax. However, during 2002, the North Carolina Department of Revenue released Directive CD-02-1, which interprets the 2001 legislation.

By way of background, corporations that are incorporated or doing business in North Carolina generally are subject to the state's franchise tax on the highest of the following three bases: (1) issued and outstanding capital stock, surplus, and undivided profits; (2) actual investment in tangible property in North Carolina; or (3) 55% of the appraised valuation of real and tangible property plus the full value of intangible property in North Carolina. Limited liability companies are not subject to the tax. Some corporate taxpayers attempted to reduce or avoid the franchise tax by transferring their assets to a controlled limited liability company that elected to be taxed as a corporation for federal income tax purposes. Because the LLC's assets were excluded from the corporate member's "actual investment in tangible property in North Carolina," this change in structure effectively eroded the North Carolina franchise tax base.

North Carolina attempted to close this "unintended loophole" by passing legislation in 2001, requiring a proportionate share of an LLC's income, assets, liabilities and equity to be attributed to a corporate member in computing its "actual investment in tangible property in North Carolina" if the member corporation would receive, directly or indirectly, at least seventy percent of the LLC's net assets upon dissolution. During 2002, the North Carolina legislature determined that a corporate taxpayer was still able to avoid the North Carolina franchise tax by transferring all or a portion of its interests in an LLC to a partnership controlled by the taxpayer. As a result, the North Carolina legislature amended the 2001 legislation in an effort to curtail further North Carolina franchise tax planning by requiring a corporation to take into account the attributes of an LLC that it controls directly or through a controlled partnership. The new legislation applies to taxes due on or after January 1, 2003.

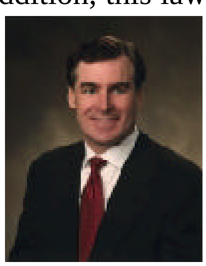
In May 2002, the North Carolina Department of Revenue (DOR) released Directive CD-02-1, which interprets the 2001 legislation. Acknowledging that North Carolina adopts the federal classification of LLCs, the Directive notes that, regardless of the 2001 legislation, a corporation is not subject to North Carolina franchise tax if its only connection to the state is as a member of an LLC that has elected to be taxed as a corporation for federal purposes. Thus, if a corporate member transferred all its North Carolina operations to an LLC that elected to be taxed as a corporation for federal purposes, then the North Carolina franchise tax would not apply to the corporate member because it would not have a taxable presence in the state. In addition, the North Carolina franchise tax would not apply to the LLC because it is not an entity subject to the North Carolina franchise tax; however, the

LLC would be separately subject to the North Carolina corporate income tax.

It is not clear, however, how the North Carolina franchise tax would apply to a REIT that operates in North Carolina through a wholly-owned LLC that elects to be taxed as a corporation for federal purposes. Such an LLC would be a disregarded qualified REIT subsidiary. Because the LLC continues to be a disregarded entity for federal purposes, despite its corporate election, it is unclear whether the North Carolina DOR would impose the North Carolina franchise tax on the REIT.

Pennsylvania Reverses Law Taxing Shareholders of PA Business Trust REITs, Deferring Action on Retroactive Legislation That Taxes Corporate REITs with Business Trust Qualified REIT Subsidiaries

Last summer, without hearings or notice, Pennsylvania passed a law that retroactively imposed Pennsylvania tax obligations on many investors in business trust REITs that owned Pennsylvania property. In addition, this law retroactively taxed corporate REITs with business trust qualified REIT subsidiaries (QRS) that owned Pennsylvania property. NAREIT organized a coalition of member REITs to seek a repeal of this law. We are pleased to report that, on December 30, 2002, then Governor Mark Schweiker (R), signed Senate Bill 958, the text of which can be found at http://www.legis.state.pa.us/WU01/LI/BI/ALL/2001/0/SB0958.htm.



Former Governor Mark Schweiker (R-PA)

S.B. 958 repeals the first part of last summer's legislation, allowing investors who are not otherwise subject to Pennsylvania tax liability to invest in Pennsylvania business trust REITs without becoming subject to Pennsylvania tax. Unfortunately, the legislation does not address the QRS issue. NAREIT will continue to advocate for a legislative change for the QRS issue in 2003.

Texas Considers Franchise Tax Legislation That Could Affect REIT-Owned Limited Partnerships and Perhaps REIT Direct Operations

Facing a potential $9.9 billion budget deficit for the 2004-2005 biennium, Texas is expected to re-examine its franchise tax law as well as other tax regimes and state programs. Specifically, both the Governor and the Comptroller have made public statements indicating their desire to "shut down" the so-called "Delaware sub" loophole, under which a corporation minimizes its Texas franchise tax liability by transferring its Texas operations to a limited partnership in which a Delaware subsidiary (or other subsidiary located outside Texas) owns a majority (e.g., 99%) limited partnership interest. Under the Texas franchise tax regime, Texas cannot impose tax on the subsidiary if its only connection to Texas is its limited partnership interest in the partnership operating in Texas. Thus, under this structure the limited partnership and its limited partner are not subject to Texas tax, which nearly eliminates the Texas franchise tax on the group.

Recently, H.B. 694 was introduced by Representative Yvonne Davis (D) (See http://www.capitol.state.tx.us/cgi-bin/tlo/textframe.cmd?LEG=78&SESS=R&CHAMBER=H&BILLTYPE=B&BILLSUFFIX=00694&VERSION=1&TYPE=B.)

As we understand it, this legislation would do the following: (1) overturn Texas' administrative rule that limited partners are not subject to tax in Texas; and (2) tax business trusts that are treated as corporations for federal tax purposes if they do business in Texas through intermediate entities. It is not clear how this legislation would affect REITs. Texas corporate law does not define "business trust," and it is not clear whether a REIT formed under the Texas "REIT" statute would be considered a "business trust" for purposes of this legislation. As drafted, the bill would be effective with initial, annual or final reports due on or after January 1, 2004, but would not tax any income or loss occurring before January 1, 2003 for the earned surplus portion of the tax.

Further, as we understand it, it is too early to tell whether this bill will move out of the Texas House Ways and Means Committee, to which it has been referred. Nevertheless, it is an important development because it is the first bill to deal with the perceived Delaware sub loophole. We would anticipate further legislation on this issue to be introduced in the next several months, and we will continue to monitor legislative developments.

Local Governments Consider Changes Affecting "Captive" REITs

Over the past several years, a few states, including Connecticut and Mississippi, have enacted legislation designed to eliminate the use of captive REITs for state tax planning. Typically, such state tax planning involves a state that allows REITs to claim a dividends paid deduction (DPD), while allowing REIT shareholders to claim a dividends received deduction. Thus, a C corporation that owns a substantial amount of real estate might organize a REIT, most likely as a subsidiary, but with 100 "friendly" parties holding small interests in the REIT. The C corporation would transfer the property to a REIT, to which it would pay rent. (A similar result can be achieved through mortgage interest instead of rental income.) The C corporation therefore would claim rental expense as a deduction against state taxable income, the REIT would claim a dividends paid deduction for the entire amount of rental income so long as it distributed 100% of its income, and the C corporation would claim a dividends received deduction (DRD) for the income distributed by the REIT. Set forth below is a discussion of various states' plans to address captive REITs.

Louisiana

Several months ago, Michael Pearson and Marcus Gaudet of the Louisiana Department of Revenue (DOR) published an article that examined the potential state revenue loss from the use of a captive REIT. In this article, Messrs. Pearson and Gaudet discussed a situation that the DOR recently had encountered of a captive REIT that involved the interplay of the dividends paid deduction and the fact that Louisiana does not tax nonresidents on REIT distributions. In this situation, a C corporation (apparently not doing business in Louisiana) had an operating subsidiary doing business in Louisiana that owned Louisiana real estate. The C corporation formed a REIT, to which the operating subsidiary's real estate was transferred. The C corporation owned 100% of the REIT's common shares, and 1050 of the REIT's 1200 preferred shares. The remaining preferred shares were divided among 100 officers of the C corporation's affiliated entities who apparently were residents in states that did not impose an income tax. The operating subsidiary then paid the REIT rent, thereby generating a new rental expense deduction against its state income. The REIT paid no tax because it distributed its income to the nonresident shareholders, and claimed a dividends paid deduction for such distribution. It is assumed that the vast majority of the REIT's dividend was paid to the C corporation. The nonresident shareholders (including the C corporation) asserted that they were not subject to Louisiana state tax on the REIT dividends because the dividends were attributable to their state of domicile.

The authors noted that the DOR was in the process of arguing that the nonresident shareholders had nexus in Louisiana, apparently as part of an audit of the C corporation's affiliated group. The authors argue that an investment in a REIT is more like an investment in a partnership, and investors "have purposefully availed themselves of the economic markets in which the REIT operates." Therefore, the REIT's activity that Louisiana seeks to tax has a "substantial nexus" to Louisiana, and the REIT's shareholders should be subject to Louisiana tax. Further, the authors noted that Mississippi disallows a DPD for a non-publicly traded REIT, and that the three private REITs in Mississippi have reported and paid corporate income tax on about $50 million in Mississippi income in their first reporting year.

The authors then suggested three legislative solutions to this type of situation: (1) disallowing a REIT's DPD, while allowing the shareholders to be exempt from tax; (2) imposing a tax on the REIT with an option for the shareholder to pay it instead; or (3) using a section 482-type approach to reallocate income.

Impact on Publicly Traded REITs

Although the authors seemed to recognize that publicly traded REITs are a "legitimate" use of the REIT structure, it is not clear whether these approaches may raise issues for publicly traded REITs. Of particular interest to our members, we note that at least one publicly traded REIT is under audit in Louisiana, and the DOR has suggested that it will attempt to assert that the REIT's nonresident shareholders are subject to Louisiana tax on their REIT dividends.

Massachusetts

On March 5, 2003, Governor Romney (R) signed S. 1949, which disallows the DRD for dividends received from REITs effective for tax years ending on or after December 31, 1999. S. 1949 should have little, if any, significant effect on shareholders of publicly traded REITs.
S. 1949 appears to be an attempt to codify the Massachusetts Department of Revenue's ("DOR") position regarding the Massachusetts taxation of a REIT's dividends. In September 2002, the DOR reissued Directive 02-12 summarizing the Massachusetts tax treatment of REITs and their shareholders. The Directive stated that although Massachusetts law does not technically conform to the federal tax Code in the context of the taxation of REIT dividends, the DOR intended to follow the federal treatment of REIT dividends for purposes of the DRD. http://www.dor.state.ma.us/rul_reg/dir/DD_02_12.htm. Prior to the introduction of the House version of S. 1949, the Massachusetts Supreme Judicial Court was expected to resolve, on a "fast-track" basis, the DOR's use of Directive 02-12 to disallow the DRD with respect to REIT dividends. Now that the legislation has become law, the judicial focus may shift to whether the retroactive application of the legislation passes constitutional muster.

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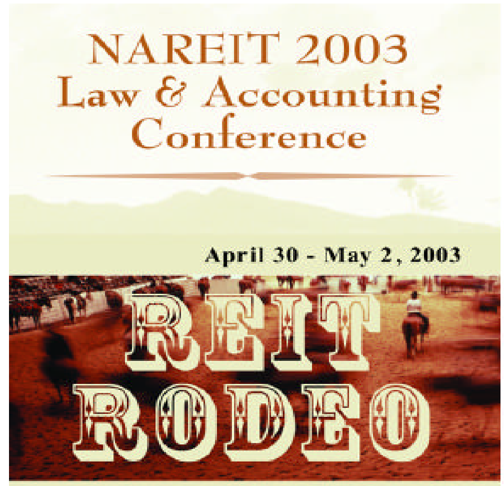
New York City

Mayor Michael R. Bloomberg's (R) Fiscal Year 2004 Preliminary Budget, http://home.nyc.gov/html/omb/pdf/tech1_03.pdf, includes a proposal that would conform the City's treatment of REIT dividends to that of the Internal Revenue Code, thereby disallowing a dividends received deduction for REIT dividends. It is not clear whether this proposal will be enacted.

North Carolina

Although dividends received from a REIT are not deductible for federal income tax purposes, North Carolina currently allows corporations to deduct REIT dividends that are attributable to income that would not have been taxed by North Carolina had the corporation earned it directly (e.g., a dividend from a regular corporation which would not have been subject to tax due to the dividends received deduction). On January 28, 2003, North Carolina's Revenue Laws Study Committee (a purely advisory committee to the North Carolina legislature) considered legislation (H.B. 1670) that would repeal this special deduction for REIT dividends and decided to recommend repeal of the special REIT dividends received deduction provisions. We anticipate that the legislature may adopt the Revenue Laws Study Committee's recommendation and enact this type of legislation.

If you have any questions about State and Local Tax issues, please contact Dara Bernstein at dbernstein@nareit.com.



Mark your calendars!

Please join us at the 2003 NAREIT Law and Accounting Conference at the Arizona Biltmore Resort & Spa in Phoenix, April 30-May 2.

For the registration brochure or to register on line go to http://www.nareit.com/meetings/laconference2003/index.cfm

The State and Local Tax Subcommittee will meet on April 30, 2003, from 4:30 p.m. to 6:00 p.m.