State & Local Tax Policy

Bulletin

May 10, 2000

With the valuable assistance of the State & Local Tax ("SALT") Subcommittee of our Government Relations Committee, co-chaired by Rick O'Connor of The Mills Corporation and Steve Ryan of Deloitte & Touche, LLP, NAREIT continues to monitor state and local tax developments in order to keep our members informed and to initiate lobbying efforts if necessary. As many of you are aware, in 1999 NAREIT was directly involved in a number of lobbying efforts, and NAREIT continues to monitor developments in various states and localities. Of particular concern to us is the apparent inclination of state legislatures to propose a variety of taxes on partnerships and limited liability companies that are doing business in their states. Such a tax is regularly proposed in Texas, was enacted last year in Tennessee, was enacted to a limited extent in Alabama, and recently has been proposed in Kentucky. The current status of our efforts concerning these taxes and other issues are summarized below. Please direct any questions or comments regarding state tax issues to Dara Freedman, REIT Counsel, at dfreedman@nareit.com.

If you haven't already registered for NAREIT's 2000 Law & Accounting Conference, you can do so online at www.nareit.com.

MARK YOUR CALENDARS

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What: NAREIT Law & Accouting Conference
Where: Doral Golf Resort & Spa
Miami, Florida
When: May 17 - 19, 2000

This year's conference will include a special state tax planning session, with a particular emphasis on investing in California, Tennessee, Illinois, Pennsylvania, and Texas. Panelists will include Ashley Ivester, Director of Tax at Gables Residential Properties, and Drew Vandenbrul, State and Local Tax Manager at Arthur Andersen, as well as the SALT Subcommittee co-chairs.

A meeting of the State and Local Tax Subcommittee is scheduled at the Doral for Wednesday, May 17, 2000, from 5:00 p.m. to 6:00 p.m. A discussion led by Don Dennis of Ernst & Young, Chris Price of CBL & Associates Properties and the Subcommittee co-chairs will focus on recent state tax developments and sales tax issues. In addition, the panel will address the state tax implications of the new federal "taxable REIT subsidiary" ("TRS") rules. Issues to be analyzed include how TRS formation and usage may affect unitary filing status as well as apportionment factors and dealing with lack of state tax conformity.

Finally, the L&A Conference will host the first-ever meeting of NAREIT's Property Tax Task Force from 10:00 a.m. to 11:30 a.m. on May 17, 2000. Open only to NAREIT corporate members, this Task Force is co-chaired by Martin Lutsky of The Rouse Company (mlutsky@therousecompany.com) and Norm Quinn of Equity Office Properties (Norman_J_Quinn@equityoffice.com). For more information about the NAREIT Property Tax Task Force, contact either Martin or Norm directly.

State Tax Website Links Available On NAREIT's Website.

NAREIT has added state tax links to the members only section of the Government Relations portion of www.nareit.com. Please let Dara Freedman know if updates are required to any links.

Second Edition of State and Local Tax Compendium Available Soon.

Stay tuned for ordering information for the Second Edition of the State and Local Tax Compendium for REITs, which is expected to be available in June. Alternatively, you may order the Compendium directly from the NAREIT website, www.nareit.com (each NAREIT corporate member will receive one complimentary copy automatically).

2000 Developments

California Considers Changing "Change of Ownership" Rules for Property Taxes.

California is considering legislation that would clarify the application of the property reassessment rules ("Proposition 13") involving a qualifying "change of ownership", i.e., a change of ownership triggering reassessment. Further, in the case of a publicly traded corporation, a partnership, or any other type of legal entity, the legislation would provide a rebuttable presumption that a single "change or ownership", and no more than a single "change of ownership", has occurred as of July 1, 2001, and each July 1 three years thereafter. This legislation also proposes the reduction of the state sales and use tax rate by .25% and the provision of a property tax credit for certain taxpayers with owner-occupied principal residences. This property tax credit is dependent upon the revenues raised by the other provisions of this bill.

California Proposes Increase of LLC Fees.

California imposes an $800 minimum franchise tax on each limited liability company ("LLC") (including single member limited liability companies) that is organized, registered, or doing business in California, as well as an annual fee based on total income from sources reportable to California for the taxable year. In FTB Notice 2000-1 (Feb. 11, 2000), the Franchise Tax Board ("FTB") proposed to increase the fees for the year 2000. As an example of the increase, beginning on or after January 1, 2000, the FTB proposed that an LLC with total income between $250,000 and $500,000 would be subject to a $1,042 fee (up from $865), and this fee would increase so that LLCs with total income of $5,000,000 or more would be subject to a fee of $9,377 (up from $7,785). The FTB held a hearing regarding the proposed increase on March 13, 2000.

Kentucky Considers Taxing Partnerships and LLCs.

Following the lead of Alabama and Tennessee, legislation was recently proposed in Kentucky that would have subjected limited liability companies ("LLCs") and limited liability partnerships ("LLPs") to Kentucky income and license (net worth) taxation. The initial proposal that passed the Kentucky House of Representatives would have subjected all LLCs and LLPs to taxation. However, an amended proposal considered by the Senate limited taxation to those LLCs and LLPs that were classified as "corporations" for federal income tax purposes. The legislative session recently was adjourned without adopting either proposal. However, the proposals are noteworthy since they highlight the growing recognition at the state tax level of the conduct of business operations through LLC and LLP form.

Massachusetts Revises Net Worth Regulation to Permit Look-Through Treatment of Partnership Interests.

The Massachusetts Department of

Revenue recently promulgated a taxpayer-favorable amendment to the Massachusetts Apportionment of Income regulation, 830 CMR 63.38.1 (the "Recent Amendment"). The Recent Amendment allows corporate partners an option for calculating the non-income measure of the Massachusetts corporate excise tax. The Recent Amendment is in response to requests from the REIT industry regarding a prior amendment (the "Prior Amendment") to the regulation that would have adversely affected UPREITs and DownREITs. Congratulations are due to Bill Wedge of Boston Properties, along with NAREIT members Ed Glazer of Goodwin, Procter & Hoar and Tim Egan and Barbara Hebert of PricewaterhouseCoopers LLP, among others, for successfully advocating for this change.

As background, REITs other than those organized as Massachusetts business trusts are subject to the Massachusetts corporate excise tax, which has an income measure and a non-income measure. Because REITs are allowed to deduct dividends paid in calculating the income measure of the excise, they generally pay only the non-income measure.

Although the definition of the tax base for the non-income measure of the corporate excise is complex and differs for various types of corporations, one common attribute of the definitions is the exclusion from the tax base of tangible property situated in Massachusetts that is subject to local taxation. In particular, if a corporation directly owns real property in Massachusetts, that property is subject to local taxation and is excluded from the tax base of the non-income measure. If, however, a corporation indirectly owns real property in Massachusetts through an ownership interest in an entity, that interest is an intangible asset that is generally included in the tax base. Thus, if a REIT holds Massachusetts real estate directly, that property is not subject to the non-income measure of the excise; however, if it holds Massachusetts real estate through an entity, that property is subject to the excise.

Originally, before the Prior and Recent Amendments were promulgated, the regulation employed a complex mechanism to allow a corporation to use the consolidated ("look-through") method of accounting for an investment in a partnership under certain circumstances. For corporations that were eligible to use this mechanism, ownership of a partnership interest was not treated as ownership of an intangible asset; instead, it was treated as ownership of a share of the partnership's assets. Such corporations benefited if the partnership's assets were subject to local tax. UPREITs often benefited from this provision.

The Prior Amendment precluded corporations from reporting their interests in partnerships on a consolidated basis. As a result of the amendment, corporations were required to report their interests in partnerships as intangible investments, rather than as ownership interests in property held by the partnerships (which, if Massachusetts real estate, was excludable from the tax base). This change often increased the non-income measure of the corporate excise.

The Recent Amendment allows corporations to report their interests in partnerships on a consolidated basis, if they are required to do so under GAAP. Electing corporate partners in a real estate partnership are treated as owning a share of the partnership's real estate and may exclude Massachusetts real property from the non-income measure. The amendment is retroactive to the effective date of the Prior Amendment, thereby eliminating its negative effects.

Mississippi - No DPD for Private REITs.

Mississippi recently enacted legislation that limits the allowance of the dividend paid deduction ("DPD") to a "publicly traded" REIT and limits the deductions of a holding company of a REIT. The legislation does not define a "publicly traded REIT" but authorizes the Mississippi Tax Commissioner to promulgate rules and regulations consistent with IRC section 269 "to prevent the evasion or avoidance of state income tax." Additionally, the legislation includes a provision that disallows the DPD (even for publicly traded REITs) to the extent traceable to income generated from properties contributed to the REIT by a shareholder or "related party" (not defined as of yet), unless the contributor itself would have received a DPD for such income (for example, property contributed by a REIT). A representative of the Mississippi taxing authority indicated that this provision would limit the DPD of a publicly traded REIT attributable to income from assets acquired by the REIT through a merger with a C corporation. It appears that this provision would not affect contributions to operating partnerships in exchange for operating partnership units.

Pennsylvania Realty Transfer Tax - Proposed Changes Could Adversely Affect REIT Transfers.

The proposed modifications to Pennsylvania's transfer tax statute contained in Senate Bill 362, initially proposed in 1999, could adversely affect REITs for transfer tax purposes on a retroactive basis. Several REITs with substantial Pennsylvania assets are closely monitoring this legislation. If you would like a copy of the legislation, please contact Dara Freedman at dfreedman@nareit.com.

Philadelphia Realty Transfer Tax-Legislative Changes Affect REIT Transfers.

The City of Philadelphia amended its realty transfer tax ordinance effective July 1, 2000, to expand its realty transfer tax. The new legislation expands the companies that will be subject to tax upon a transfer of 90% or more of the interests therein.

Under current law, upon a transfer of 90% or more of the interests in a Real Estate Company in a 3 year period, the Real Estate Company becomes an Acquired Real Estate Company, and Philadelphia realty transfer tax is imposed on the company. The tax is 3% of the fair market value (for real estate tax purposes) of the Acquired Real Estate Company's Philadelphia real estate.

A company is a Real Estate Company if:

a) (1) it is primarily engaged in the business of holding, selling, or leasing real estate; (2) 90% or more of the company is owned by 35 or fewer persons; and (3) the company derives 60% or more of its annual gross receipts from the ownership or disposition of real estate and holds real estate the value of which comprises 90% or more of its entire tangible asset holdings; or

b) it owns, directly or indirectly, as 90% or more of the value of its assets, an interest in a Real Estate Company as defined in (a).

For this purpose, real estate means real estate in Philadelphia. As a result, only a company whose principal assets are Philadelphia real estate could be a Real Estate Company.

Effective July 1, 2000, the definition of Real Estate Company has been changed by (1) reducing from 90% to 50% the percentage of a Real Estate Company's asset value that must be represented by real estate and (2) expanding the definition of real estate, for this purpose, to include all real estate, wherever located. As a result, many more companies will be Real Estate Companies. For example, qualified REIT subsidiaries or operating partnerships that own only a small amount of Philadelphia real estate (but a large amount of real estate outside of Philadelphia) now may be considered Real Estate Companies. Accordingly, the transfers of these entities (or a merger of a REIT with interests in such entities) could result in application of the City's realty transfer tax.

A Real Estate Company becomes an Acquired Real Estate Company, and subject to the realty transfer tax, upon a transfer of 90% or more of the interests therein. Thus, a transaction in which Sellers transfer to Buyer 89% of the interests in a Real Estate Company, followed by Seller's transfer to Buyer of the remaining 11% of the Real Estate Company three years and one day after the original transfer as part of the original transaction (an "89-11 Transaction") technically is not covered by the City's transfer tax.

However, effective for transactions taking place after June 30, 2000, a transfer will be deemed to occur within 3 years of another transfer if a legally binding commitment to make the later transfers is made within such 3-year period. As a result, an 89-11 Transaction would subject a Real Estate Company to realty transfer tax.

The City has not issued formal guidance regarding the effect of this change on a preexisting 89-11 Transaction when the second transfer occurs after June 30, 2000. However, a representative of the City at least has stated that the tax would not apply to transfers resulting from agreements made prior to July 1, 2000. Further, if applicable to an 89-11 Transaction, the tax would apply at the time of the later transfer. Written guidance is expected.

State Tax Implications of Federal "Built In Gain" Regulations Unclear.

The IRS recently issued proposed and temporary regulations dealing with the recognition of gain by a corporation that converts to a REIT or otherwise transfers former subchapter C corporation appreciated assets to a REIT in a tax-free transaction. Under the recently issued regulations, a C corporation is treated as liquidating and therefore recognizing gain on appreciated assets if it converts to REIT status or transfers any assets to a REIT in a carryover basis transaction. Gain recognized by a REIT within 10 years after the acquisition of such property from a C corporation generally will be treated "similar to" foreclosure property income. It is not clear for federal purposes exactly what aspects of the foreclosure property rules apply to gain recognized during this 10-year period, and it is even less clear how these rules apply for state purposes. In April, NAREIT submitted comments to the IRS on these regulations, and testified at the May 10th hearing concerning the regulations. NAREIT specifically recommended that any gain recognized during the 10-year "recognition period" retain the same character as such gain would have if it had been recognized by the original transferor. Copies of the submission can be found in the members only section of the Government Relations portion of www.nareit.com.

Tennessee -Lobbying Effort Continues.

NAREIT continues to work with a coalition of corporate members to seek legislation that would repeal or reduce the impact of Tennessee's new franchise and excise taxes on REIT-owned limited liability entities. On January 19, 2000, three state Senators and four state House members filed legislation (available under the Government Relations portion of www.nareit.com) that would mitigate the effect of last year's enactment of an income tax and net worth tax on partnerships. For excise tax purposes, a limited partnership would deduct from its tax base income proportionate to the REIT's ownership interest in the partnership. This income would be taxed at the REIT level when it could be offset by the dividends paid deduction. For franchise tax purposes, the REIT would be allowed to deduct its investment in lower level partnerships from its tax base, and the franchise tax base would be changed to apportioned net worth. Generally, the legislation would apply to tax years ending on or after the date of enactment.

We extend special thanks to members of our NAREIT Tennessee Tax Coalition who have worked very hard to get us to this point. Because Tennessee is experiencing a severe budgetary crisis and the Governor's current plan to raise revenues through the enactment of an income tax has met with considerable resistance, we anticipate a rough road in enacting this legislation. Stay tuned for further details.

1999 Update

Alabama Passes Limited Partnership Privilege Tax with a Liability Cap.

As noted in the last SALT Bulletin, last year the U.S. Supreme Court in South Central Bell Telephone Co. v. Alabama declared Alabama's franchise tax unconstitutional and remanded the case to the Alabama Supreme Court to determine the appropriate remedy. Since then, Alabama's legislature met in special session to create a replacement for the franchise tax. Initially, Alabama was considering a tax on pass-through entities, without a cap, modeled on the 1999 Tennessee tax. In part as a result of our lobbying efforts in Alabama spearheaded by Colonial Properties Trust, this potential disaster was averted.

Although Alabama did enact a privilege tax on pass-through entities based on net worth (reduced by investments in subsidiary entities doing business in Alabama), under this legislation, the tax is generally capped at $15,250 per entity for the year 2000, and $15,000 per entity subsequent years. While REITs (both corporations and trusts) doing business in Alabama are now subject to the privilege tax based on their net worth, net worth of partnerships doing business in Alabama will reduce their privilege tax base significantly, if not entirely. As enacted, REITs are subject to a higher maximum of $500,000 per entity (which would decrease to the "standard" maximum if a constitutional amendment to increase the corporate income tax passes). We understand that a constitutional amendment to increase the corporate income tax has passed (thus permitting a reduction the maximum privilege tax for REITs), but we also understand that some action may be necessary by the legislature in order to reduce the maximum privilege tax for REITs. In addition, we understand that the Alabama legislature will be considering a technical corrections bill (copy not yet available at press time) that may affect the privilege tax.

Florida Still Considering Whether Partially Completed Property Is Subject to Florida Property Taxes.

NAREIT (on behalf of a coalition of affected corporate members), along with the National Multi Housing Council, filed with the Florida Supreme Court a motion to appear as amicus curiae in the property tax case of Fuchs v. Robbins. Although the motion was denied, the judges did review the motion's accompanying brief, and, accordingly, are aware of NAREIT's arguments. At stake is hundreds of million dollars of increased property taxes that would be levied annually on buildings under construction. NAREIT continues to monitor the issue and will advise of further developments. The Supreme Court has scheduled oral argument in this case for May 11, 2000.

Reminder - Pennsylvania Taxes Can Be Reduced By Using a Business Trust REIT or QRS.

Pennsylvania's current policy is to tax REITs and their QRSs as separate entities for purposes of the corporate net income (CNI) and capital stock/foreign franchise (CS/F) taxes. Pennsylvania does allow the dividends paid deduction for CNI purposes. REITs and QRSs formed as business trusts are statutorily excluded from both CNI and CS/F taxes whereas those formed as corporations are subject to tax. Therefore, the acquisition of Pennsylvania properties through business trusts can minimize future CNI and CS/F liabilities. Note that Pennsylvania's tax methodology is not well-settled. Be on the lookout for possible changes in the future.

Many thanks to the NAREIT members who contributed to this SALT Bulletin: Wendy Kotzen from Reed Smith Shaw & McClay; Steve Ryan from Deloitte & Touche, LLP; Jane Steinmetz and Barbara Hebert from PricewaterhouseCoopers LLP and Drew VandenBrul from Arthur Andersen LLP. Please contact NAREIT's REIT Counsel, Dara L. Freedman, at (202) 739-9446 or e-mail: dfreedman@nareit.com, if you would like to contribute to the State & Local Tax Policy Bulletin or to advise of any state tax changes or developments that affect the REIT industry.