State & Local *Tax Policy* Bulletin

January 8, 2002

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Florida Considers Expanding its Sales Tax on Services, Including Non-Residential Rent - Florida Senate President John McKay (R) has released a proposal to amend Florida's Constitution. Contained in Senate Joint Resolution 938, effective July 1, 2004, this proposal would (a) subject all sales of goods and services, other than sales of groceries, health services, prescription drugs, residential rent, and basic residential telephone service, to the general state sales tax and (b) lower the sales tax rate from 6% to 4%. The legislature could allow future exemptions only by a 3/5 vote in each house in a general law that deals with no subject other than the specific exemption, provided that the exemption met one of the following purposes: encouraging economic development and competitiveness; supporting education, governmental, religious, or charitable initiatives or institutions; or securing tax fairness by reducing or eliminating regressive tax burdens. Also, the legislature could approve a higher sales tax rate by a 3/5 vote of both houses. Commercial rent (apparently including apartment rent) would not fall under one of the stated exemptions to the sales tax, but of course, the legislature could exempt it specifically from the tax's application.

In 1986 the Florida legislature eliminated a number of sales tax exemptions, including the exemption for professional services and sparked a huge public outcry. Shortly after the sales tax on services became effective in 1987, the Florida governor was forced to call a special session of the legislature, which repealed the services tax several months later. Unlike the 1987 tax, Senator McKay's attempt would modify the Florida Constitution, thereby being impossible to repeal absent a Constitutional amendment. SJR 938 has been referred to the Florida Senate's Committee and Finance and Taxation and is currently scheduled for a public hearing on January 9, 2002. All members of the public are welcome at this hearing, but we are not yet aware of any groups that are planning to testify at the hearing. We are monitoring the legislation and will keep you updated of future developments.

At Least Temporarily, Alabama Does Not Increase the Privilege Tax But Does Require Nonresident Partner Withholding-As we previously reported to you, Governor Siegelman (D) called a

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December 2001 special session of the Alabama legislature to address a potential increase in the tax rate and the liability cap of the Alabama privilege tax. While this session ended without any increase to the privilege tax, the Governor has vowed to continue his battle to increase the privilege tax in 2002. Many thanks are due to Howard Nelson and Stephen Greene of Colonial Properties Trust for monitoring the Governor's plans and opposing any increase to the privilege tax. We will keep our members apprised of any developments in 2002 and may organize a coalition of interested members to oppose any efforts to increase the privilege tax.

One bill that did pass in the 2001 special session (HB 5) requires that limited liability entities ("LLEs") with nonresident members or doing business in Alabama file an income tax return for years beginning after December 31, 2000. Unless the nonresident member or partner files an Alabama tax return and pays the appropriate tax, the LLC must withhold either 6.5% for corporate partners or 5% for non-corporate partners of the partner's distributive share of the LLE's net income apportioned and/or allocated to Alabama.

North Carolina Closes Perceived Franchise Tax "Loophole" Involving "Controlled" LLCs - North Carolina recently enacted a change to its franchise tax that would affect corporations (such as REITs) that own North Carolina property through "controlled" limited liability companies ("LLCs"). REITs that own North Carolina through UPREITs formed as partnerships should not be affected by this law change. Apparently, the legislature believed that corporations were avoiding North Carolina franchise tax inappropriately by forming LLCs (either wholly-owned or owned along with related parties) to hold North Carolina real property. By doing so, the corporation could deduct from its capital stock base for franchise tax purposes its investment in controlled LLCs, thereby reducing its franchise tax base.

By way of background, North Carolina's franchise tax base is calculated based on the greater of three measures: (a) apportioned capital, (b) book value of North Carolina "tangible property" and (c) 55% of the appraised value of North Carolina "tangible property." Taxpayers that own North Carolina property through lower-level entities basically use only the apportioned capital measure to determine their franchise tax because they own no "tangible property" in North Carolina. Additionally, in the past, North Carolina allowed REITs that owned North Carolina assets through lower-level entities to deduct from the capital base their interest in these lower-level entities. Thus, a REIT that owned North Carolina property through an Operating Partnership ("OP") could deduct its investment in the OP, and a "traditional" REIT that owned North Carolina property through a wholly-owned or majority-owned LLC similarly could reduce its franchise tax liability.

Effective for taxes due on or after January 1, 2002, North Carolina has modified its franchise tax law in a manner that disadvantages traditional REITs that own North Carolina property through "controlled" LLCs. The new law does not appear to affect REITs that operate through OPs.

Under the new law, if a corporation is member of a limited liability company ("LLC"), and the LLC's governing law provides that 70% or more of the LLC's assets, after payments to creditors, must be distributed upon dissolution to the member corporation or to includible corporations of an affiliated group in which the member corporation is includible, then (i) a percentage of the LLC's income, assets, liabilities, and equity is attributed to that member corporation and must be included in the member corporation's computation of North Carolina franchise tax, and (ii) the member corporation's investment in the LLC is not included in the member corporation's computation of North Carolina franchise tax. The attributable percentage is equal to the percentage of the LLC's assets, after payments to creditors, that would be distributable to the member corporation under the LLC's governing law if the limited liability company dissolved as of the last day of the member corporation's taxable year. In all other cases, none of the LLC's income, assets, liabilities, or equity is attributed to a member corporation.

As a result of this change, a REIT that meets the 70% requirement would be required to include in its franchise tax base the tangible property owned by the LLC, thereby potentially increasing its franchise tax liability significantly. While conversion of the LLC to a partnership might be the simplest solution to any increase in North Carolina franchise taxes, any restructuring plan should be preceded by projections of potential tax liability. Alternatively, using leverage to reduce the franchise tax base also may reduce franchise tax liability.

NAREIT's 2001 Update to the Second Edition of the State and Local Tax Compendium for REITs should be available in the first quarter of 2002. Corporate members are entitled to one complimentary copy. Additional copies for Corporate members are $250 each. Associate members may purchase the 2001 Update for $250, and nonmembers may purchase the update for $400. Please contact David Howard at dhoward@nareit.com if you would be interested in ordering a copy.

MARK YOUR CALENDARS

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NAREIT's 2002 Law & Accounting Conference is May 8-10, 2002, at
The Broadmoor Hotel and Resort in Colorado Springs, Colorado.
Meeting information will be posted at www.nareit.com as it becomes available.