NAREIT State & Local Tax Policy Bulletin

National Association of Real Estate Investment Trusts®
REITs: Building Dividends and Diversification®

State & Local Tax Policy Bulletin

INTRODUCTION

This is the first State and Local Tax (SALT) Policy Bulletin of 2006, and a number of the issues discussed below highlight the continued focus by many states on the taxation of REITs and their shareholders. Despite the federal tax model of a single incident of taxation at the shareholder level, some states persist in their belief that REITs should be subject to tax at the entity level as well. This Bulletin includes discussions of the recent trend of imposing state franchise and other taxes on REITs and their affiliates as highlighted by new legislation in Texas and Tennessee, new audit activity in Tennessee and a legislative proposal in Montana.

We encourage those companies whose affiliates have owned, or do own, properties in Tennessee to review the discussion that follows concerning the recent audit activity there and the conference call scheduled for Thursday, June 29 at 3 p.m. EDT to discuss whether a coordinated industry response to the audits would be appropriate. Please RSVP to Ryan Kilpatrick at rkilpatrick@nareit.com if you plan to attend and he will forward you the call-in information.

Highlights

Tennessee Enacts New Legislation and Begins New Audits - Page 4

Texas Enacts New Legislation - Page 8

Legislative/Regulatory Developments Affecting Income/Franchise Taxes

KENTUCKY - SPECIAL SESSION

NAREIT thanks Michele Randall of Deloitte & Touche LLP for alerting us to this development.

In two of last year's SALT Bulletins, August 2005 and November 2005, we discussed Kentucky's new legislation, effective Jan. 1, 2005, that imposes Kentucky's income tax or alternative minimum tax on pass-through entities. On June 21, 2006, Kentucky Governor Ernie Fletcher (R) issued a proclamation, calling the Kentucky General Assembly into a special session to begin June 22, 2006. The purpose of the special session is to enact legislation that contains the following: 1) a complete repeal of the taxation of gross receipts and gross profits for companies with gross receipts and gross profits of $3 million or less this year; 2) a preservation of the reduction of the tax on corporate profits from 7% to 6% next year; and, 3) the treatment of the taxation of net income of pass-through entities like limited liability companies in the same way as federal law. We have not yet seen a copy of the draft legislation, and, consequently, we are not aware of its treatment of REITs and their affiliates. Our understanding is that the legislation may move the incidence of taxation

Gov. Ernie Fletcher (KY)

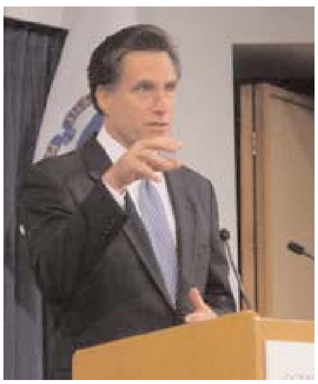
1875 I Street, NW, Suite 600, Washington, D.C. 20006-5413 • 202-739-9400, 800-3NAREIT • 202-739-9401 fax
www.nareit.com • www.investinreits.com

from the pass-through entity to its REIT or qualified REIT subsidiary owner, when it could be reduced by the dividend paid deduction. We will forward more information to our members once we become aware of it.

MASSACHUSETTS - NEW LEGISLATION

Background

As part of some "clean-up" legislation in 2004, Massachusetts passed legislation that had an adverse effect on REITs doing business in Massachusetts. The adverse effect resulted from the removal of one of the formulas used by REITs to calculate the non-income (net worth) portion of what Massachusetts calls the "corporate excise" (tax). Prior to the change, taxpayers could choose either a "domestic" or a "foreign" formula to compute this liability; the 2004 legislation removed the "foreign" formula. Due to this change, many REITs faced significant increased tax liabilities in Massachusetts.



Gov. Mitt Romney (MA)

With Boston Properties taking the lead, NAREIT organized a coalition of nine member REITs to seek legislative relief to re-instate the foreign formula. The Massachusetts Department of Revenue did not oppose the change as long as the foreign formula was required to be used by all REITs that were required to file with the Securities and Exchange Commission annual and other reports as specified in Section 13 or Section 15(d) of the Securities Exchange Act of 1934, as amended - essentially REITs that are publicly traded or whose securities are required to be publicly registered due to their asset or shareholder size. The NAREIT-supported legislation was signed into law on Dec. 8, 2005 and is retroactively effective for tax years ending on or after Aug. 9, 2004. See Section 22 of the legislation for the specific provision.

New Regulations

The Department of Revenue recently issued regulations concerning this new law, Technical Information Release, 06-6, which essentially tells affected taxpayers to file amended returns for the retroactive time period if they are due a refund.

MICHIGAN - EXPECTED LEGISLATION

Background

For many years, REITs and other business entities doing business in Michigan have been subject to a business tax in Michigan known as the "single business tax" or SBT. The SBT is somewhat complicated to administer, but in simplified terms, it subjects a REIT's rental income to tax in Michigan without the benefit of the dividends paid deduction.

Possible SBT Repeal

NAREIT recently learned that enough Michigan citizens have signed a petition so that the Michigan legislature will be forced to repeal the SBT within 40 days after the signatures are verified (which is expected) effective no later than Dec. 1, 2007. It is expected that the legislature will replace the SBT with some other tax structure, but whether it will

Gov. Jennifer Granholm (MI)

be a net income tax (possibly permitting the dividends paid deduction), a gross receipts tax, or a sales tax remains to be seen. One of NAREIT's corporate members has engaged lobbyists to monitor the legislative environment, and NAREIT recently hosted a conference call among interested companies to gauge the level of interest for either monitoring legislation or actually advocating for certain legislation. At this point, a six member, bipartisan legislative committee is soon to begin the task of recommending alternative tax structures. If your company is interested in becoming involved with, and financially supporting, a legislative effort organized by NAREIT, please contact Dara Bernstein at dbernstein@nareit.com.

MONTANA - PROPOSED LEGISLATION

Background

As we have noted above, a few states have imposed new taxes (other than income taxes) on REITs and their affiliates. In some cases, the state's proposal is attributable to the inappropriate use of captive REITs. However, in some cases, the state specifically targets all REITs, focusing on the REIT's reduction in franchise tax liability at the entity level, while typically ignoring the economic benefits of other taxes (especially property taxes), economic development and on the taxes generated by dividends to REIT shareholders provided by REITs.

Dan Bucks

Montana is the only state currently considering ignoring the federal income tax rules pertaining to REITs and potentially disallowing a dividends paid deduction to the state corporate income tax. The current head of its Department of Revenue (DOR), Dan Bucks, is the former head of the Multistate Tax Commission (MTC), a joint agency of state governments. In 2004, the MTC released a document that highlighted potential tax abuses involving captive REITs.

In 2005, at the urging of the DOR, the Montana House passed a bill that contained a number of anti-REIT measures, including a provision that would have denied the dividends paid deduction to a REIT; and a measure that would have allowed a Montana shareholder in a REIT to exclude from income a REIT dividend (to the extent that the REIT had paid Montana tax – a provision of questionable constitutionality). At the time, NAREIT worked closely with two of its corporate members with Montana property holdings and operations to oppose these provisions which were later removed from the legislation. As a result, no anti-REIT measures were passed in Montana last year.

2006 Legislative Proposals

The Montana legislature continues to study this issue, and NAREIT continues to work with its concerned corporate members to maintain the status quo. As part of this effort, NAREIT has engaged a lobbyist in Montana and has joined a business-related advocacy organization, the Montana Taxpayers Association, which played a useful role in opposing last year's anti-REIT legislation.

The Montana DOR recently released its proposals for the 2007 legislative session, once again including a proposal to deny the dividends paid deduction for REITs (or to require out-of-state shareholders in REITs to pay Montana tax on income derived from Montana properties).

NAREIT will continue to work with its REIT members in Montana to work against enactment of the DOR's proposals for 2007. If your company is interested in becoming more involved with our advocacy efforts in Montana, please contact Dara Bernstein at dbernstein@nareit.com.

TENNESSEE - NEW LEGISLATION AND AUDIT ACTIVITY

Background

In 1999, Tennessee extended its franchise (net worth) and excise (income) tax to pass-through entities. As a result, REIT-owned partnerships faced an additional level of taxation not present in the federal system or in the tax systems of nearly every state with an income-based (as opposed to gross receipts or other system) tax system. Following the tax change, NAREIT organized a coalition of approximately 40 REITs to advocate for a legislative change that would tax REIT-owned pass-through entities only to the extent of their non-REIT owners. The coalition was successful in obtaining the enactment of such legislation in 2000.

In March 2006, NAREIT became aware that the Tennessee Department of Revenue (DOR) was circulating a proposal to repeal the 2000 legislation applicable to REITs. The DOR considered all REITs, even publicly traded REITs, a "loophole" that permits avoidance of the Tennessee franchise and excise taxes.

NAREIT Tennessee Tax Coalition Re-Formed

As a result of the DOR's proposal, NAREIT once again organized a coalition of approximately 29 REITs (Coalition) to advocate for maintenance of the 2000 legislation. On May 7, 2006 an Associated Press article appeared in the Tennessee papers in which Governor Phil Bredesen (D) stated that it was his intention to close the "REIT loophole." Ironically, the DOR specifically viewed publicly traded REITs as causing a reduction in Tennessee tax revenues, but ignored the potential revenue losses caused by captive REITs. The DOR was unmoved by arguments that REIT investment causes increases in sales taxes, property taxes, state taxes on dividends, jobs, and perhaps, most importantly, economic development.

Ultimately, the NAREIT Coalition reached a compromise under which: 1) the excise tax treatment of REIT-owned entities would remain the same; 2) Tennessee residents would no longer pay income tax (under provisions called the "Hall Tax") on dividends they directly receive from a REIT; and, 3) REIT-owned partnerships would become liable for franchise taxes as they were before the 2000 legislation.

The legislative language, contained as an amendment to H.B. 4048 and its companion bill, S.B. 3930, did not completely comport with our understanding of the compromise, and we provided comments to the DOR seeking certain changes. Specifically, the DOR:

Gov. Phil Bredesen (TN)

1) revised the excise tax provisions with respect to REIT-owned partnerships to apply only to "publicly traded" REITs as specifically defined (which did not include publicly registered, non-exchange traded REITs);

2) re-wrote the substantive provisions of the excise tax provisions to "exempt" a partnership from excise tax to the extent it distributes 100 percent of its net earnings (or, according to the bill, "net losses") directly or indirectly to a publicly traded REIT (Section 12) or, for a partnership that distributed less than 100% of net earnings to a publicly traded REIT, to require it to reduce net earnings by "an amount" distributed directly or indirectly to a publicly traded REIT (Section 14); and,

3) proposed an effective date of Jan. 1, 2006.

NAREIT provided comments to the DOR requesting that: 1) no changes be made to the excise tax provisions, or, at the very least, "public REIT" include a REIT required to file reports with the SEC under the 1934 Act; 2) the term "distributes" in Sections 12 and 14 be replaced with "allocates," 3) potential double taxation of corporate structures be eliminated, particularly of hotel REITs who are allowed under the federal rules to lease to a taxable REIT subsidiary (TRS), which is subject to an additional level of franchise tax; 4) the exemption from shareholder-level tax on REIT dividends include those REIT dividends received by pass-through entities like mutual funds and include capital gains and return of capital distributions; and, 5) the effective date be prospective.

Ultimately, the DOR accepted only the effective date change, and, accordingly the REIT provisions in the amendment are effective after July 1, 2006. It is not clear how this effective date will apply to REIT distributions received by shareholders during 2006 - that is, whether only distributions received after July 1, 2006, will be exempt from tax, or the exemption will be pro-rated for distributions received throughout the year. Further, it is not clear how to apply the franchise tax changes because the DOR made verbal assurances that the shareholder-level exemption will apply not only to income distributions, but also to capital gain and return of capital distributions (we have been advised that Tennessee currently taxes returns of capital other than in liquidation of a company). The DOR further made assurances that it would work with any taxpayer facing double taxation and possibly invoke its authority under T.C.A. § 67-4-2014 (permitting adjustments to clearly reflect income and franchise tax liability) to make changes, but of course these assurances are not binding.

As noted above, this legislation was part of House Bill 4048, approved by the House on May 26, 2006, and by the Senate shortly thereafter. On June 15, 2006, the bill was transmitted to the governor for his action. The governor has not yet signed H.B. 4048, but is expected to do so shortly.

It is possible that we may see some technical corrections to this legislation during the 2007 legislative session. We would urge you to review the applicable sections of the new excise tax provisions with your tax advisors, as the new language apparently may lead to some interesting, and possibly unintended, results under your company's current business practices.

Please Send Us Your Questions

To the extent you have any questions, please forward them to Dara Bernstein at dbernstein@nareit.com because we may have the opportunity to present questions to the DOR in the near future.

More Audit Activity Under Prior Law For REITs Without Tennessee "Nexus"/Coordinated Industry Response?

NAREIT thanks Joe Gurney of Deloitte & Touche LLP and Steve Ryan of Grant Thornton LLP for their contributions to the summary below.

NAREIT is aware of at least six partnerships owned by non-Tennessee-based REITs that have received notices of assessment with respect to their lower-tier partnerships under the prior excise tax provisions. Specifically, NAREIT has been advised by several members that the DOR has recently changed its informal policy on the availability of the REIT excise and franchise tax exemptions that were enacted in 2000.

The DOR is challenging the excise tax deduction provided to REIT-owned partnerships (Tenn. Code Ann. § 67-4-2006(b)(2)(M)) when the REIT is not actually doing business in Tennessee even if the REIT has: 1) filed a tax return and paid the $100 minimum due; and/or, 2) has qualified to do business in Tennessee. In connection with this policy change, the DOR has begun issuing excise tax assessments to several REIT-owned partnerships that claimed the deduction on their Tennessee returns.

Interestingly enough, quite a few of the REIT under audit of which NAREIT is aware received their audit notice in the several weeks after the 2006 legislation was passed by the Tennessee legislature. Furthermore, the DOR's apparent change in policy that REITs without Tennessee nexus should not be entitled to the special excise tax rule certainly conflicts with their negotiating posture that the excise tax treatment would remain the same as under current law. No doubt the DOR would argue that the pre-2006 law was ambiguous and the 2006 changes were simply a way to make the law clearer. However, one could certainly take the position that had NAREIT been aware that the DOR was changing its policy concerning the excise tax treatment of REITs, NAREIT would have sought some type of legislative clarification. Given that it appears that some technical corrections will be needed with respect to the new excise tax provisions, it may be appropriate to consider legislative guidance.

The tax advisors of the REITs under audit are not aware of any effort by the DOR to make this new policy public through regulation, ruling or other publication. On the contrary, DOR personnel have historically indicated that their interpretation of the 2000 legislative intent was that the deduction should be provided regardless of whether the REIT was doing business in Tennessee and that the deduction should also be provided to other pass-through entities such as single-member limited liability companies (for example, see FAQ #36). The advisors are aware of several amended Tennessee tax returns that have claimed refunds based on the excise tax REIT-ownership deduction for REITs that were not doing business in Tennessee that have been audited and received refunds paid over the past several years. Additionally, prior to the policy change earlier this year, the advisors were aware of several taxpayers who received audit assessments for this issue which were protested and the assessments were ultimately cancelled following a DOR review.

Some of the arguments we have heard raised against the DOR's position include: 1) a literal reading of the statute does not require that the REIT have Tennessee nexus; 2) any DOR policy change should be applied only on a prospective basis; and, 3) the requirement that the REIT have Tennessee nexus leads to unconstitutional discrimination against out-of-state REITs. See Farmer Bros. Co. v. Franchise Tax Board, 108 Ca. App. 4th 976 (2003) (California Court of Appeals held that law permitting taxpayers a dividends received deduction only from corporations that were subject to California tax was facially discriminatory and violated the Commerce Clause of the U.S. Constitution)(link not available).

It should be noted that if a taxpayer attempts to solve the excise tax issue by arguing that the REIT does have nexus, there is a risk that the DOR will raise a separate franchise tax issue involving the flow-up of apportionment values in computing the REIT's apportioned net worth. We are aware that the DOR has recently attempted to shift its informal policy on the flow-up of apportionment values from REIT-owned partnerships that are doing business in Tennessee. In at least one situation when a REIT was doing business in Tennessee, the DOR has argued informally that the REIT should flow-up its share of apportionment values from a Tennessee partnership that claimed the REIT-ownership deduction. The flow-up of apportionment factors issue is likely to affect both in-state and out-of-state REITs. Since a REIT typically has a very large net worth, this position could result in a significant additional franchise tax liability.

Similar to the excise tax policy change, it is important to note that over the past several years DOR personnel have informally indicated that a REIT was not required to flow up apportionment values from a REIT-owned partnership that was doing business in Tennessee. Moreover, prior to this policy change, some tax advisors were aware of refund claims that have been paid after DOR review of this issue.

The apportionment factor controversy arises because the Tennessee statutes that detail the computation of the excise tax and franchise tax apportionment formulas contain two separate provisions describing the proper treatment of apportionment values from investments in pass-through entities. There are specific rules addressing flow up within the property, payroll and receipts factor rules (see Tenn. Code Ann. § 67-4-2012(b)(4), (d)(5), (g)(4) and 67-4-2111(b)(4), (d)(5), (g)(4)). Additionally, there is a general rule provided in a separate paragraph following the various factor rules (see Tenn. Code Ann. § 67-4-2012(k) and 67-4-2111(k)).

The specific flow-up rules provided for each factor state that a taxpayer should only flow-up apportionment values from any general partnership and from any limited partnership, S corporation, limited liability company or other entity treated as a partnership that is not doing business in Tennessee. This rule provides a strong implication that the owner should not flow-up apportionment values from partnerships and LLCs that are doing business in Tennessee. However, the general rule in the separate paragraph provides that a taxpayer should flow-up apportionment values from any pass-through entity in proportion to the taxpayer's distributive share of the pass-through entity's income, unless the taxpayer is excluding the pass-through entity's income in computing its Tennessee net earnings under a deduction other than the REIT-owned partnership deduction. Since these paragraphs appear to provide two separate rules for inclusion of pass-through entity apportionment values, it is unclear how they should apply. In general, we would expect that the specific rule should trump the general rule when the two rules are in conflict. However, the resolution of this ambiguity remains to be seen.

Potential Reduction in Property Tax Assessments Due to Franchise/Excise Tax Increase

Those companies that were involved in the 1999-2000 initiative may remember that one of the arguments NAREIT made to the legislature was that the extension of franchise and excise tax to REIT-owned partnerships would cause these partnerships to seek reductions in property tax assessments due to the decrease in value of their Tennessee properties. We understood that certain companies had begun the process of seeking re-assessments prior to the enactment of the 2000 legislation that reduced the partnerships' tax base to the extent owned by a REIT. Now that the franchise tax has been extended fully to partnerships, it might be appropriate to revisit the issue of whether property tax re-assessments should be sought. We are not aware of whether these re-assessments could be done on a retroactive basis as well, but if so, those companies facing disallowance of the excise tax at the partnership level for prior years may want to consider requesting re-assessments of their property values for property tax purposes.

NAREIT Conference Call to Discuss Strategy

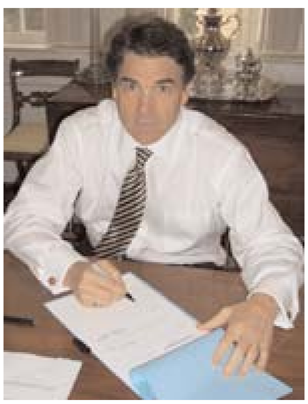
NAREIT will host a conference call on Thursday, June 29 at 3 p.m. EDT to discuss a potential industry-wide response to the recent audit notices, including the possibility of funding a court challenge and/or a legislative initiative. Please RSVP to Ryan Kilpatrick at rkilpatrick@nareit.com if you would like to join the call, and he will send call-in information.

TEXAS - NEW LEGISLATION

Background

For almost a decade, Texas had been considering fundamental tax reform in order to improve the financing of its public school system as well as to reduce the property tax burden on state residents. As part of this effort, Texas had been considering legislation to deal with the "Delaware sub" exception to its franchise tax that exempts corporate limited partners in Texas partnerships from franchise tax (by treating them as not "doing business in" Texas). Limited partnerships were not subject to the franchise tax under prior law.

Because such legislation could have been drafted to apply to REITs or REIT-owned partnerships, NAREIT organized a coalition (the Coalition) of approximately 25 REITs in 2003 to lobby for appropriate treatment of REITs in any such legislation. NAREIT engaged two lobbyists and one lawyer on behalf of the Coalition to advocate for appropriate treatment of REITs and REIT-owned partnerships under any legislative change. The Coalition has continued to work with its consultants through 2006.



Gov. Rick Perry (TX)

Significant Tax Reform and Property Tax Reduction Enacted This Year

Texas Governor Rick Perry (R) called a special legislative session in Texas this year that began on April 17, 2006. As a result, on May 18, 2006, Governor Perry signed House Bill 3 (H.B. 3), to close the so-called "Delaware sub" exception and to reform the Texas franchise tax system, and on May 31, 2006, the governor signed H.B. 1, which provides for property tax reduction. Under the new tax system, corporations and business trusts (including REITs) and limited partnerships doing business in Texas (with yearly revenues in excess of $300,000) generally will be taxed on their "revenue" reduced by certain adjustments (the so-called "margin tax").

With respect to a taxable entity that is treated as a corporation for federal income tax purposes, the first margin tax returns and tax payments will be due May 15, 2008, based on the entity's fiscal year ending during 2007.

As part of the legislative arrangement, the new margin tax was coupled with a significant reduction in property tax rates, contained in H.B. 1, which sets forth the amounts of the rate reductions and their phase-in period. H.B. 1 reduces property taxes by 17 cents per $100 of assessed value in 2006, and 33 cents per $100 of assessed value in 2007. We have been advised to expect technical amendments to be made to the new margin tax in the regular legislative session beginning in January 2007.

Applicability of Margin Tax to REITs and REIT-Owned Partnerships

Although the Coalition had been successful over the past several years in securing proposed legislation that would have substantially maintained the status quo for REITs, the politics of 2006 brought a somewhat different outcome. Because 2006 is an election year and because this year the legislature sought to impose some form of taxation on almost all business entities, the broad-based tax system contained in H.B. 3 prevailed. Furthermore, because the margin tax is conceptually less related to the "net income" type of tax used in the federal and most state tax systems, it was quite difficult this time to argue that a dividends paid deduction for REITs should be allowed under the margin tax.

In sum, the margin tax will affect REITs and REIT-owned partnerships as follows. REITs and qualified REIT subsidiaries are not considered taxable entities provided they own no real property directly (other than that occupied for business purposes). However, the tax generally will apply to both corporate and business trust REITs and/or real estate partnerships that own Texas property. The tax will apply to a real estate partnership regardless of the extent of a REIT's ownership in the partnership. It appears that mortgage REITs, and partnerships owned by mortgage REITs that earn interest income will be exempt from the new tax as passive entities. Further, the tax will apply to any corporate or business trust REIT that is not "doing business" in Texas (e.g., when a REIT operates in Texas solely as a limited partner), but owns real property somewhere "directly" and also owns 80% or more of a real estate partnership that owns real property in Texas. Technically, the law treats taxpayers that are part of an affiliated group to file a "combined return" if they are part of a unitary business. It appears that even those members that do not have nexus in Texas are included as part of the affiliated group.

Second, a tax rate of 1% applies to the tax base ("taxable margin"). Taxable margin is defined as the lesser of: 1) "total revenue" apportioned to Texas less the cost of goods sold" or "compensation" at the election of the taxable entity, or 2) 70% of "total revenue" apportioned to Texas. "Total revenue" is calculated by reference to line items in federal tax forms. The entity's margin is apportioned to Texas based on gross receipts. A REIT is not permitted to claim a dividends paid deduction as part of this tax regime. We have been advised that reimbursements under a lease (e.g., for common area maintenance expenses) will be included in total revenue.

Partnerships and Corporations Technically Calculate "Total Revenue" Differently

Because of a reference to certain federal income tax calculation methods, the legislative language of H.B. 3 would permit a partnership to calculate its "total revenue" based on its net rental income, while a corporation would calculate "total revenue" based on its gross rents, after which either the cost of goods sold or compensation deduction would be claimed (unless the 70% cap resulted in a lower tax base, in which case, the tax base would be 70% of total revenue). To address this inconsistency, after the fact the legislature passed a resolution indicating that its intent also had been to tax partnerships based on "gross rents." Many tax advisors suggest that partnerships should base their margin tax calculation based on "gross" rents as a result of this resolution. Further, we expect that this issue of inconsistency will be addressed prior to the effective date of the new legislation.

Interplay Between H.B. 1 and H.B. 3 May Reduce Taxes for Some REITs and Increase Taxes for Other REITs Related to Pass-through Lease Terms

In general, we understand that the new margin tax will not be able to be passed through to tenants. However, certain leases may contain language that would authorize real estate owners to pass through ad valorem (and possibly other) taxes to tenants, and, therefore, you should consult with your advisors to determine whether the margin tax could be considered an ad valorem or other tax that could be passed through to tenants.

To address this potential issue, a draft technical amendment was circulated during the 2006 special session which would have permitted a pass-through of the margin tax to tenants by specifically designating it an ad valorem tax (presumably because it was created to replace property tax revenues attributable to the reduction in property tax rates). NAREIT supported this amendment, although it did not pass. It may be considered by the legislature in 2007.

Due to the interplay between H.B. 1 and H.B. 3, we anticipate that the net effect of the two bills may be to modestly reduce or slightly increase overall Texas tax liability for apartment, lodging, self-storage, timber and other REITs that benefit from the reduction in property tax rates (because they do not have to pass through property tax relief to their tenants). With that said, we have received anecdotal evidence that property assessments have increased substantially, thereby significantly reducing any potential savings. Conversely, any office, retail, or industrial REIT that must contractually pass through property tax savings to tenants may well face overall increased tax liability in Texas due to the margin tax.

Comptroller's Form to Estimate Tax Liability

The Texas Comptroller has released a spreadsheet that allows taxpayers to estimate their margin tax liability. Interestingly, this form indicates that partnerships should calculate their total revenue based on their "net rental revenues," rather than gross revenues. As noted above, we expect the confusion regarding this issue to be resolved in 2007.

Technical Corrections Expected in 2007

As noted above, we have been told to expect significant technical corrections in 2007. NAREIT and the Texas Tax Coalition currently are in discussions with our consultants regarding whether to continue our legislative advocacy efforts in 2007. Depending upon the advice of our consultants, we may attempt to seek the ability to treat the margin tax as capable of being passed through to tenants as an ad valorem tax (since the margin tax was enacted essentially as a substitute for the previously-existing property tax) and/or to allow for some types of deductions against gross revenues based on the argument that it is not fair that manufacturers are able to deduct the significant amount of cost of goods sold while property owners essentially have no deductions. If your company is interested in becoming more involved in a 2007 legislative effort (including by means of a financial contribution to the effort), please let Dara Bernstein know at dbernstein@nareit.com.

Lawsuits Challenging New Margin Tax

We also expect to see any number of lawsuits challenging the constitutionality of the new margin tax. In fact, one such lawsuit by "Citizens Lowering Our Unfair Taxes" (CLOUT) has already been filed which challenges the new tax as violating spending limits.

Additional Summaries

For official legislative summaries of H.B. 3, please see the bill analysis by the Ways & Means Committee and the bill analysis by the Senate Research Center. For further information on H.B. 3, please go to the Texas Legislature's Website.

Legislative Developments Affecting Transfer Taxes

NEW HAMPSHIRE

NAREIT thanks Steve Ryan of Grant Thornton LLP for alerting us to this development.

H.B. 1444, was signed May 22, 2006, by New Hampshire Gov. John Lynch (D) and concerns the real estate transfer tax (RETT). Under the legislation, the RETT will be imposed on transfers of interests in entities that own interests in real estate holding companies. The law is effective July 1, 2006.

Under H.B. 1444, a real estate holding company is any business entity that "is engaged principally in the business of owning, holding, selling, or leasing real estate and which owns real estate or an interest in real estate within the state." This is a broader definition than under prior law. H.B. 1444 also states that "transfers of interests in an entity that holds, either directly or indirectly, an interest in a real estate holding company shall be considered to be a transfer of an interest in the real estate holding company to the extent of the ownership of the entity in the real estate holding company."

Unlike similar legislation in other states (such as a proposal that re-appears every year in Maryland), H.B. 1444 does not require the transfer of a controlling interest in a real estate entity. Instead, in a curious result for widely held REITs, it appears to impose the transfer tax on the transfer of ANY interest in the REIT if the REIT owned an interest in a partnership that owned some New Hampshire property. With that said, it is not clear how New Hampshire would collect the tax as there is no withholding or other collection mechanism. NAREIT is in the process of contacting the New Hampshire tax authorities to seek clarification that the RETT would not apply to the transfer of an interest in a publicly traded REIT.

NEW YORK

NAREIT thanks Morris Kramer and Lary Wolf of Robert & Holland LLP for alerting us to this development.

Extension of Reduced Real Estate Transfer Tax Rate for REITs

Gov. George Pataki (NY)

On April 26, 2006, the New York State Legislature overrode Governor Pataki's veto of a budget bill that contained a provision relating to the extension of the reduced transfer tax rate for certain real property transfers to REITs (S. 6460/A.9560). By way of background, the New York law previously provided a reduced tax rate of $1 for each $500 of consideration or fractional part thereof to apply to conveyances of real property to a REIT (other than in connection with the formation of the REIT). This reduced rate expired Sept. 1, 2005. Under the new legislation, the reduced tax rate is retroactive to the expiration date of Sept. 1, 2005, but it expires Aug. 31, 2008. The New York State Department of Taxation and Finance has issued guidance for those companies that paid the higher transfer tax of $2 per $500 of value on or after September 1, 2005 with respect to a qualified conveyance to an existing REIT or to a partnership or corporation in which a REIT owned a controlling interest.

Under this guidance, taxpayers may claim a refund within two years from the date of payment and should use Form TP 592.2, Claim for Real Estate Transfer Tax Refund. The refund is the difference between the tax paid and the tax computed at the reduced rate.

For further information, please contact
Dara Bernstein,
dbernstein@nareit.com
or
Tony Edwards,
tedwards@nareit.com.