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NAREIT State & Local Tax Policy

Bulletin

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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I. Several States Consider, and Two Enact, Fundamental Tax Reform

A. Kentucky: Tax on Pass-Throughs and Alternative Minimum Tax

On March 18, 2005, Kentucky Governor Ernie Fletcher (R) signed tax reform legislation, H.B. 272. The following summarizes the highlights of the new legislation.

This publication is for general informational purposes only and is not intended to constitute legal or tax advice. Always consult your own legal or tax advisor concerning your individual situation.

Repeal of Corporate License Tax

For tax years ending on or after Dec. 31, 2005, first, the new law repeals the corporate license tax, a tax based on capital, that applied only to corporations. Thus, corporate REITs, but not business trust REITs, had been subject to the corporate license tax.

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Expansion of Entities Now Subject to Corporate Income Tax

For tax years beginning on or after Jan. 1, 2005, the new law expands the income tax to additional limited liability entities including REITs, limited partnerships, and limited liability companies (LLCs), including single-member LLCs. Newly taxable entities should evaluate their 2005 estimated tax liability.

Corporate Income Tax Rates Lowered

For tax years beginning on or after Jan. 1, 2005, the highest corporate tax rate is reduced from 8.25% to 7% on all amounts over $100,000. For tax years beginning on or after Jan. 1, 2007, the rate drops from 7% to 6% on these amounts.

New Corporate Taxation Regime

Effective Jan. 1, 2005, a taxpayer must pay the higher of: a) the corporate income tax, or b) a new alternative minimum tax. The new alternative minimum tax (similar to New Jersey's "alternative minimum assessment") is based on: a) the lesser of a rate of 9.5 cents per $100, applied to Kentucky gross receipts, b) Kentucky gross profits at a rate of 75 cents per $100; or (c) $175.

While the dividends paid deduction (DPD) of a REIT and/or a qualified REIT subsidiary (QRS) should continue to apply to reduce the income tax, the REIT or QRS could face a new Kentucky tax liability in the form of the alternative minimum tax. Furthermore, limited liability pass-through entities like limited partnerships are subject to the new tax, and are not permitted to deduct distributions.

Avoidance of Double Taxation

Kentucky taxable income of REITs, QRSs, and other non-individual owners of interests in limited liability pass-through entities (such as limited partnerships and limited liability companies) does not include income attributable to the pass-through entities, thus avoiding double taxation. Individual owners of interests in limited liability pass-through entities will be entitled to receive a credit representing their share of the tax paid by the entity.

New "Nexus" Standard: Corporate Limited Partners Not "Doing Business" in Kentucky

Kentucky Revised Statutes § 141.010(25) has been amended to define "doing business" in Kentucky. (Taxpayers "doing business" in Kentucky are subject to the new corporate tax regime). This definition includes the holding of an interest in a general partnership as "doing business" in the state, but it does not address the holding of an interest in a limited partnership or LLC that is considered doing business in Kentucky. Accordingly, a REIT may not be considered doing business in Kentucky merely by owning an interest in a limited partnership or LLC that is itself subject to tax.

Conformity to American Jobs Creation Act of 2004

Additionally, the law conforms to American Jobs Creation Act of 2004 (which included the REIT Improvement Act of 2003), excluding bonus depreciation.

Application to "Qualified REIT Subsidiaries"

Under the legislation, a qualified REIT subsidiary "that is included in the return filed by the real

estate investment trust parent" is not required to file a separate return, but the term "qualified REIT subsidiary" is not defined. While one of our REIT members did file a request with the Kentucky Revenue Cabinet seeking a ruling that its indirectly wholly-owned partnership, which is a disregarded entity for federal tax purposes, could be considered a QRS for these purposes, this ruling request recently was denied. If the partnership could have been considered a QRS, the disregarded partnership would have been included in the parent REIT's return, and the parent REIT, as mentioned above, would have been entitled to a DPD. If considered a partnership, the disregarded partnership will be required to file a separate return from the parent REIT, and it will not be entitled to deduct distributions to the parent REIT for purposes of the new tax. Unlike a similar tax on pass-through entities in Tennessee, there is no exclusion from the income tax to the extent that a pass-through entity is owned by a REIT.

Mandatory Filing of Consolidated Returns

Finally, all "includible corporations" that are connected through an ownership interest of 80% or more, including LLCs and limited partnerships with nexus in Kentucky, must file a consolidated tax return (concerning both the corporate income tax and the alternative minimum tax).

Unfortunately, REITs are excluded from the definition of "includible corporation." Accordingly, REITs are not permitted to file consolidated returns with lower-tier partnerships or LLCs. While a REIT cannot file a consolidated return with its QRS, the QRS is included in the parent REIT's return. At least one NAREIT member REIT is interested in seeking a judicial or legislative change to allow a REIT to file a consolidated return with its lower-tier partnerships in LLCs, thereby allowing the REIT to offset the income of lower tier entities with the DPD. Please contact Dara Bernstein at dbernstein@nareit.com if your company is interested in joining and contributing to such an effort.

B. Ohio

NAREIT thanks Phil Ardrey of Glimcher Realty Trust and Kathy Monteleone of Grant Thornton LLP for their contributions to the summary below.

Background

On June 30, 2005, Governor Bob Taft (R) signed into law H.B. 66, which overhauls Ohio's tax system. Effective July 1, 2005, changes will be phased in over the next several years. The major changes are the elimination of the corporation franchise tax and the tangible personal property tax for most taxpayers with "substantial nexus" in Ohio, and the imposition of a Commercial Activities Tax (CAT). The CAT is imposed on most legal entities, including those that previously were not subject to corporation franchise tax, such as REITs, qualified REIT subsidiaries, and partnerships.

Application of the CAT

The CAT is a new tax imposed for the privilege of doing business in Ohio and is primarily measured by Ohio gross receipts. "Gross receipts" include amounts realized from sales or exchanges of property (except for receipts from the sale or exchange of assets described in section 1221 or 1231 of the Internal Revenue Code), rents, and performance of services. Excluded from the CAT are the distributive or proportionate shares of receipts and income from a pass-through entity.

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Tax Rate of the CAT

The tax rate, once the CAT is fully phased in, will be 0.26% of gross receipts. An additional minimum tax of $150 is imposed on every taxpayer with Ohio gross receipts over $150,000. The first $1 million of taxable gross receipts are exempt from the CAT. For the first six months of the CAT (the period of July 1, 2005 through Dec. 31, 2005), the minimum fee is $75 and the $1 million exemption is pro-rated to $500,000.

Phase-in of the CAT

The corporation franchise tax will be eliminated ratably over a five-year period beginning with the 2006 tax report. The CAT is phased in over five years beginning July 1, 2005 in 20% increments.

The phase-in of the CAT means that the tax rate of .0026 must be multiplied by the "phase-in" percentages to ascertain the proper tax during the "phase-in" years. The "phase-in" percentages are as follows, with respect to Ohio gross receipts received during the applicable time frame:

July 1, 2005 through March 31, 2006	23%
April 1, 2006 through March 31, 2007	40%
April 1, 2007 through March 31, 2008	60%
April 1, 2008 through March 31, 2009	80%
April 1, 2009 and thereafter	100%

Because REITs, QRSs, and partnership had not been subject to the corporate franchise tax in the past, their new liability will come only from the phased-in CAT. Taxable REIT subsidiaries that had been subject to the Ohio corporate franchise tax in the past will have to calculate their liability based on the sum of the phased-out corporate franchise tax and the phased-in CAT. Note that the full corporate franchise tax will apply (in addition to the phased-in CAT) for the 2005 calendar year because the corporate franchise tax phase-out does not begin until 2006.

See the following information from the Ohio Department of Revenue for more detail: a chart describing the phase-in of the CAT, a brochure on frequently asked questions, and an informational brochure.

Affiliated Groups Including REITs and REIT-Owned Entities

Certain affiliated groups generally are permitted to exclude receipts from transactions between one another if the group elects to file as a "consolidated elected taxpayer" and the group includes all members either: a) at least 50% of the value of whose equity is commonly owned; or, b) at least 80% of the value of whose equity is commonly owned. If this election is made, all members of the consolidated group must be included, even those who do not have "substantial nexus" in Ohio. The benefit of making this election is to eliminate intercompany transactions.

Related taxpayers that elect not to make the "consolidated" election will be forced to file as a "combined taxpayer" if they meet a "more than 50% ownership" test. It is unclear whether the Department of Taxation will interpret the more than 50% ownership test to apply regardless of whether the person has U.S. Constitutional nexus with Ohio. A "combined taxpayer" group may not eliminate intercompany transactions. As a result of these two options, REITs and their advisors should calculate which option would lead to the lowest potential tax liability prior to making (or failing to make) an election.

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There are several U.S. constitutional issues that are implicated and each entity should consider the implications of how the entity and its affiliated members should file with respect to the CAT. Furthermore, there are several other special rules associated with affiliated groups and certain inter-state transactions, and the "situsing" provisions of the CAT are generally modeled after the current corporation franchise tax situsing rules that are utilized for the sales factor.

CAT Registration Required by November 15, 2005

Taxpayers must register for the CAT by Nov. 15, 2005 and pay a one-time registration fee that is credited to the taxpayer's first payment of the CAT. Taxpayers whose taxable gross receipts do not exceed $1 million may elect to be calendar year taxpayers and are required to file and remit the CAT minimum tax by the 40th day after the close of the calendar year. All other taxpayers will be calendar quarter taxpayers and are required to file and remit the CAT by the 40th day following each calendar quarter. The first CAT returns for both types of filers must be filed and paid by Feb. 10, 2006.

Inability to Pass Through CAT Liability to Tenants

There has been some mention of whether taxpayers, like REITs, could pass through CAT liability to their tenants through lease agreements. Our understanding is that, while H.B. 66 did include provisions permitting such pass through, these provisions were vetoed by the governor.

One of our members has been advised that it may be possible to have these provisions re-inserted in a likely technical corrections bill in the fall. Certain technical omissions and errors have already been discovered by practitioners, the Tax Department, and others. The governor would not be permitted to veto only certain items of such technical corrections bill, since he only has line-item veto power in bills with appropriations. Therefore, the governor would have to veto the entire bill or sign the entire bill, without line-item vetoing only certain provisions. This member may undertake a lobbying effort to include such a provision in a technical corrections bill. If your company would be interested in contributing and participating in such an effort, please contact Dara Bernstein at NAREIT at dbernstein@nareit.com.

Real Property Tax Rates Will Increase by 10%

Another provision in H.B. 66 relates to the taxation of real property. Specifically, real property taxes with respect to most real property in Ohio are effectively increased by the elimination of the 10% rollback on commercial and industrial real property.

Link to H.B. 66

The full text of H.B. 66 can be found at the Ohio Department of Taxation's Web site. (Please use this link with caution as we have been advised that some, if not all, of the online versions of H.B. 66 do not include references to the governor's line item vetoes.)

C. Texas

Background

By way of background, Texas has been considering fundamental tax reform since 2003 for three primary reasons: a) to modify its system for funding schools, b) to lower property tax, and, c) to modify the ability of corporate limited

partners to invest in Texas partnerships without corporate franchise tax liability. The final issue is known as the "Delaware sub loophole" even though its use does not violate the law. In response to reports in 2003 that Texas planned to overhaul its tax structure in a manner that could increase substantially the potential franchise tax liability of REITs, NAREIT organized a coalition of about 25 member companies to advocate for appropriate tax treatment for REITs and their affiliates. No substantive tax legislation was passed during the 2003 legislative session or the 2004 special legislative session. For more details regarding the legislation that was considered during these sessions, see our last SALT Policy Bulletin.

Set forth below is a summary of the legislative developments to date under the regular 2005 legislative session and the two special legislative sessions called by the governor during 2005.

Because there has been no tax legislation to date, a summary of the various legislative vehicles is provided below to provide context in the event a subsequent legislative vehicle is based on one of the earlier vehicles. Furthermore, the expansion of the franchise tax to REITs and/or REIT-owned entities should be considered in light of the expected property tax changes. Our understanding is that certain types of REITs may benefit more from property tax reductions than others.

Regular Legislative Session

The regular 2005 legislative session began on Jan. 11, 2005 and ended May 30, 2005. During the regular session, both the House and Senate passed their own versions of a tax bill, in each case known as H.B. 3. Click here for the House version. The Senate version is not available online.

Under the House version of the bill, which would have imposed a choice of a "reformed franchise tax" or a payroll tax, it appeared that "REITs and their subsidiaries," and possibly their partnerships, would not have been subject to the franchise tax but arguably would have been subject to the payroll tax. The term "REIT and its subsidiaries" was not defined. Furthermore, the House bill contained an exemption for "investment partnerships," but it did not define that term. In addition, the House bill contained property tax relief.

Under the Senate version of H.B. 3, taxpayers also would have faced a choice of a franchise tax or payroll tax, but subject to a minimum tax on gross receipts. The Senate version did not contain the House's language regarding REITs and their subsidiaries (other than a provision that the dividends paid deduction would still apply). The Senate version also would have exempted certain "passive partnerships," which was defined very narrowly (as partnerships that paid no compensation to any employee or independent contractor other than for legal or accounting services relating to the partnership and which earned mostly passive income). It was widely believed in the business community that most real estate partnerships would not have been able to fit under this definition of passive investment partnership due to payments to service providers.

After the House and Senate passed their respective versions of H.B. 3, a conference committee comprised of House and Senate members attempted to reconcile the two versions, Although we never saw any statutory language, our understanding is that the House version of H.B. 3 was modified by House conferees in conference committee to provide an exemption for REITs and qualified REIT subsidiaries from

the revised franchise tax (and payroll tax). Also, the "investment partnership" exception to the franchise tax that was in the House-passed version of H.B. 3 was defined in conference committee by House conferees to include most partnerships at least 90% of whose gross income was derived from "passive" sources such as rents from real estate so long as only certain limited services (such as customary cleaning and security) were performed by the landlord.

Ultimately, House and Senate conferees were unable to come to an agreement on H.B. 3, and accordingly, both bills died, and the legislature adjourned.

First Special Legislative Session

Following the end of the regular legislative session, Governor Rick Perry (R) called a special session to begin June 21, 2005 through July 20, 2005, and, a new version of a tax bill, H.B. 3 was filed on June 21, 2005. Click here to see the bill. A brief summary follows.

In general, the "as-filed" version of H.B. 3 would have greatly expanded the current version of the Texas franchise tax, both in terms of the type of tax imposed and in terms of the entities subject to the tax.

Reformed Franchise Tax:

Under the "as-filed" version of H.B. 3 in the first special legislative session, the franchise tax would have changed to the following: the choice between the lesser of the "old" franchise tax (greater of .25% of net worth or 4.5% of net income) or 1.15% of taxable wages (all wages paid to Texas employees), subject to a minimum tax of 50% of the greater of the two alternatives.

Expansion of Franchise Tax Base:

All entities that meet the definition of "taxable entity" would have been subject to the new franchise tax. Taxable entities would have included partnerships and business trusts. All taxable entities "doing business" in Texas would have been subject to the new franchise tax. In general, limited partners in limited partnerships would have been considered "doing business" in Texas.

Exemption of REITs and QRSs from New Franchise Tax/Question Regarding REIT-Owned Partnerships

REITs and QRSs would have been exempted from the definition of "taxable entity" and accordingly from the new franchise tax. In terms of REIT-owned partnerships, the only additional exemption that apparently could have applied was one for "passive investment partnerships." A passive investment partnership was defined as a partnership at least 90% of whose federal gross income consists of passive investment income, including dividends and interest. Rents from the lease of real property was included in the definition of "passive investment income," but only if the lessor provided no services to the lessee other than customary cleaning and security. Partnerships owned by mortgage REITs may have qualified under this exemption if at least 90% of their gross income was from interest and other passive income. However, it appears that equity REIT-owned partnerships whose gross income consisted primarily of rental income probably would not have qualified under this exemption because of the broader range of services typically provided to tenants.

Nexus Change:

As noted above, H.B. 3 would have treated both general partners and limited partners as "doing business in Texas" and therefore subject to the franchise tax.

Property Tax Reduction:

The bill would have lowered the property tax rate from $1.50 per $100 of value to $1.15 per $100 of property value, but school districts could have, with voter approval, levied an enrichment tax of up to 15 cents per $100 of value for the first year of the biennium. In the second year of the biennium, the maximum rate would have gone down to $1.10 but school districts could have, with voter approval, levied an enrichment tax of up to 15 cents per $100 of value.

Sales Tax Rate Increase:

H.B. 3 proposed increasing the sales tax rate from 6.25% to 7.25%.

Governor Perry's Plan:

Also on June 21, 2005, Governor Rick Perry (R) released details of his tax plan, which was much narrower than the "as-filed" version of H.B. 3. Under his plan, limited partners in partnerships that do business in Texas would have been subject to the existing Texas franchise tax. The governor's plan would not have extended the franchise tax to partnerships or business trusts, nor would it have changed the calculation of the existing tax. Business trust REITs are exempt from the current franchise tax. It is not clear how corporate REITs that are limited partners would have been treated under the governor's plan.

On July 7, 2005, the House passed yet another version of H.B. 3 by a fairly narrow margin. Rather than expanding the franchise tax to virtually every type of business entity as some earlier tax bills would have done, it would have treated corporate owners of trusts and limited/general partnerships as subject to the Texas franchise tax. (This was intended to "close" the "Delaware sub loophole.")

Section 2A.03 of the House version of H.B. 3 contained a provision specifically applicable to REITs and qualified REIT subsidiaries (QRSs), such that : a) corporate investors in business trust REITs and QRSs would not have been treated as "doing business in Texas" (and therefore subject to the franchise tax) merely as a result of such investment; and, b) REITs and QRS limited partners would not be treated as "doing business in Texas" merely as a result of holding a limited partnership interest, provided that the limited partnership satisfies the REIT gross income and asset tests. Thus, in general, a corporate REIT or corporate QRS that held a qualifying limited partnership interest in a Texas limited partnership (or that held an interest in a business trust REIT or business trust QRS) would not have been subject to the franchise tax. REITs that are organized as trusts would not have been taxable under the House bill and neither would their beneficiaries (shareholders).

Issue for REITs Under House Version of Tax Bill:

We understand that some REITs, particularly those in an UPREIT structure, often invest in Texas through a limited partnership owned by two limited liability companies (LLCs), one of which owns a general partnership interest (and is thus currently subject to Texas franchise tax) and one of which owns a limited partnership interest (and

is thus not currently subject to Texas franchise tax). Under the House version of H.B. 3 (as well as the Senate version described below which is more limited), the latter LLC would have been subject to the Texas franchise tax despite its ultimate ownership by a REIT or REIT-owned partnership. However, it may be possible to restructure the limited partnership investment so that, instead of being owned by an LLC, it is owned by another limited partnership or by a subsidiary REIT.

Senate Version of the Tax Bill:

The Senate passed its version of H.B. 3 on July 11, 2005. It also would have "closed" the "Delaware sub loophole," reduced property taxes to $1.30 per $100 of value in 2005 and $1.25 per $100 in 2006, raised the sales tax .5% to 6.75%, provided that the franchise tax would have sunset Jan. 1, 2008, and stated that a 15 member commission appointed by the Governor, House and Senate would have to make recommendations to the 80th Legislature convening in January 2007 on how to replace the franchise tax. Unlike the House-passed version of H.B. 3, the Senate version did not contain any specific provision related to REITs. As a result, under the Senate-passed version of H.B. 3, REITs and/or QRSs that are limited partners in limited partnerships doing business in Texas also would have been viewed as doing business in Texas. Click here to access the Senate version of H.B. 3.

Conference Committee Could Not Agree on Tax Bill:

The conference committee was unable to agree on a final version of H.B. 3, and accordingly, the first special legislative session in 2005 ended July 21, 2005 at midnight without a tax bill.

Governor Perry Calls Second Special Legislative Session

Following the end of the first special legislative session, Governor Perry then called a second special legislative that began the very next day, July 21, 2005, at 10 a.m.

REIT-Favorable Tax Bill Defeated in House; No Other Tax Bill Introduced:

Also on July 21, 2005, the House Ways and Means Committee passed the same version of H.B. 3 that had passed the House in the prior special session and which is described above. Essentially, this bill would have treated corporate limited partners as doing business in Texas as a result of owning a limited partnership interest in a partnership that was doing business in Texas. REITs or qualified REIT subsidiaries would not have been treated as doing business in Texas merely by owning a limited partnership interest in a limited partnership that was doing business in Texas so long as the partnership met the REIT gross income and asset tests. The full House voted on H.B. 3 on July 26, 2005, and the measure was overwhelmingly defeated.

Outlook

While there are fewer than 20 days left in this legislative session, prospects for another tax bill are unclear. We understand that the following are options:

1) Because tax bills must originate in the House, the House may file and approve another tax bill. The Senate then would need to pass its own tax bill, which, if different from the House's bill, would need to be reconciled with the House bill.

2) If the session ends without an agreement, the governor could call a third special session. He is facing criticism regarding his leadership abilities from potential political opponents. Thus, he may feel pressure to come up with some tax legislation.

3) Legislators could wait for the Texas Supreme Court to issue a decision regarding whether the school finance system is constitutional. The court is expected to rule on this issue within the next few months, and its decision could force a complete overhaul of the current system or only minor changes.

NAREIT will continue to work with the Texas Tax Coalition and its consultants to advocate the best position for REITs, consistent with the single level of taxation structure adopted by Congress and the vast majority of states.

II. State Tax Challenges to REIT Taxation (Idaho, Louisiana, Maryland, Montana, and South Carolina)

A. Background

NAREIT has become aware of a number of state legislative and judicial challenges to the typical state tax treatment of REITs. Virtually every U.S. state with an income-based tax system follows the federal tax treatment of REITs and allows a dividends paid deduction (DPD) to a REIT in calculating its state tax liability. Mississippi is the only U.S. state with an income-based tax system that limits the DPD to publicly traded REITs. Additionally, states with an income tax impose that tax on REIT shareholders domiciled in their state.

Recently, states have become aware of the use of REITs as a tax planning device by C corporations. In a typical structure, a C corporation forms a REIT in order for the C corporation to claim the dividends received deduction from REIT dividends while the REIT claims the dividends paid deduction on that same income.

In fact, the Multistate Tax Commission, a joint agency of state governments established to improve the fairness, efficiency and effectiveness of state tax systems as they apply to interstate and international commerce, and preserve state tax sovereignty, released a presentation at one of its conferences in 2004, in which it detailed some of what it considers to be the abusive uses of REITs by C corporations. As a result of some of these tax structures, a number of states have considered tax legislation that would negatively affect REITs, either by eliminating the dividends paid deduction or by requiring REITs to withhold tax on nonresident shareholders.

NAREIT has been monitoring these efforts, and when appropriate, has provided input to the relevant state personnel. NAREIT has also engaged a prominent state tax law expert to provide advice on how best to present the position of the REIT industry with respect to these proposals. The proposals and other related state initiatives (including one court case) are described below.

B. Idaho: Proposed Legislation That Would Have Disallowed the DPD for ALL REITs

The 2005 Idaho legislation session included one bill, H.B. 26, that would have disallowed the DPD for all REITs. This bill originated in the Idaho State Tax Commission. The bill was based on the Commission's view that very few REIT

shareholders were resident in Idaho. Accordingly, from its perspective, income generated by Idaho properties was not taxed at the REIT level or the investor level. It did not focus on the property or sales taxes generated by REIT-owned properties in Idaho. NAREIT was scheduled to participate on a conference call with a State Tax Commission member, a member of the Idaho Bankers Association, a C corporation apparently contemplating REIT status, and one of our REIT members with extensive Idaho property holdings. However, this call never took place.

Our understanding is that this bill is essentially dead for the 2005 legislative session. Nevertheless, NAREIT is working with corporate members with properties in Idaho in order to monitor developments in Idaho for the upcoming legislative session. NAREIT may meet with State Tax Commission officials to explain why legislation similar to H.B. 26 is flawed and detrimental to Idaho's economic well being.

C. Louisiana: Court Allows Louisiana to Tax Nonresident Shareholders; Legislation Enacted to Deny DPD to Captive REITs

Recent developments in Louisiana include both a Louisiana Supreme Court case and new legislation. Both are described in more detail below.

In Bridges v. Autozone Properties, Inc., 2004-C-0814 (LA, March 24, 2005), the Louisiana Supreme Court held that Louisiana had jurisdiction to impose its income tax on the dividends received by the Nevada corporate shareholder of a C corporation's captive REIT that owned Louisiana property.

Facts

In the Autozone case, a Nevada corporation (Parent), formerly a seller of automobile parts, had reorganized in 1995 by forming, among other companies, a subsidiary REIT (REIT) in which it owned 100% of the common, and 90% of the preferred stock, and an operating company (Stores). Following the reorganization, Parent functioned solely as a Nevada holding company. REIT owned the real property where Stores operated, including 68 Louisiana stores, and Stores paid rent to REIT. Although Stores and REIT both filed Louisiana tax returns, Stores' Louisiana income was reduced by its rental payments to REIT (and presumably by its royalty and interest payments to Parent), and REIT's Louisiana income was reduced by its dividends paid deduction of 100% of its taxable income to Parent. Parent did not file a Louisiana tax return, and because Nevada did not impose income tax on Parent, Parent paid no income tax on dividends from REIT.

Holding

The state in Autozone argued that the dividends received by Parent were actually rent from Louisiana real estate, and accordingly, was subject to Louisiana income tax by virtue of an existing state statute that imposed state tax on rental income from Louisiana real property. The Louisiana Supreme Court held that Louisiana could constitutionally impose tax on a "nonresident shareholder's investment income based on its investment in a separate corporation engaging in business activities in the taxing state, when the state has provided benefits, opportunities, and protections which contributed to the profitability of the in-state activities." Practitioners have criticized this holding because

it was reached despite that the nonresident received "dividends," not "rent" from Louisiana sources, and there was no Louisiana statute imposing a withholding tax on nonresident shareholders. Nevertheless, it causes some concern because it appears to hold that states with the appropriate withholding tax statutes could subject nonresident REIT shareholders to tax.

Apparently, the taxpayer in Autozone requested a rehearing of the decision, which the Supreme Court denied because the application was untimely. The Chief Judge of the Supreme Court did file a concurring decision in which he agreed with the denial of rehearing, but he also pointed out that he believed that the case may have been incorrectly decided, and that the State of Louisiana's best remedy would be to obtain a legislative remedy that would prevent these types of "schemes" in the future.

Following the Autozone decisions, NAREIT became aware that the Louisiana Department of Revenue was attempting to find a sponsor for legislation that would deny the DPD to all non-public REITs. NAREIT worked with the DOR to secure broader language that continues to allow the DPD to all REITs that are either publicly traded or are not "captive REITs," such as the one in the Autozone case. The term for such a REIT is "qualified REIT." A "qualified REIT" is any REIT other than a REIT more than 50 percent of the voting power or value of the beneficial interests or shares of which are owned or controlled, directly or indirectly, by a single **taxable** "C" corporation that is not a REIT or a qualified REIT subsidiary. Under the legislation, publicly traded REITs and "qualified REITs" continue to be entitled to the DPD for Louisiana tax purposes, while a REIT that is more than 50% held by a **taxable** C corporation no longer would be entitled to the DPD. [A qualified REIT includes a REIT more than 50% held by a C corporation that is exempt from tax under IRC § 501(c).]

The DOR was successful in having a bill incorporating this DPD proposal introduced as a substitute for an existing bill, H.B. 818 (later renamed H.B. 888), relating to corporate taxes. Governor Kathleen Blanco (D) signed H.B. 888 on June 30, 2005, and it is effective for tax years beginning after Dec. 31, 2005. Click here for a link to H.B. 888.

D. Maryland Bill That Would Have Imposed State Taxation on Nonresident Shareholders in REITs Is Not Passed

Introduced by the Chairman of the House of Delegates Ways and Means Committee, Sheila Hixson (D), H.B. 1581 would have required REITs to withhold Maryland tax on distributions to nonresident shareholders attributable to income from Maryland properties. NAREIT viewed H.B. 1581 a significant enough concern to engage a Maryland consultant to assist in advocating against this proposal. Furthermore, both NAREIT and the Chief Executive Officer of Washington REIT, Ed Cronin, submitted written testimony for the Maryland House Ways and Means Committee hearing on the bill held on March 29, 2005. The focus of the objections were that publicly traded REITs could not comply with the proposal because they are not able to identify their shareholders. Furthermore, the proposal would have put Maryland out of step with virtually every other state that impose taxes based on income.

NAREIT also requested its members with Maryland properties to send letters of opposition to key lawmakers, which many members did. No oral testimony was presented at the hearing, other than by an aide to the bill's sponsor. The committee did not vote on the bill, and accordingly, no further action was taken on the bill following the committee hearing. The bill accordingly died.

E. Montana: Proposed Legislation Would Have Disallowed DPD for All REITs or Would Have Imposed a Minimum Tax

The 2005 Montana legislative session included two bills relevant to REITs that were Montana taxpayers. The first, S.B. 513, would have denied the DPD to all REITs in computing Montana tax liability. The bill also would have permitted REIT shareholders resident in Montana to exclude from their Montana income REIT dividends that had been subject to the Montana tax. The second, S.B. 521, would have imposed a minimum tax on all Montana taxpayers, including REITs, and would not have permitted a DPD.

NAREIT worked with two REIT members with properties in Montana to oppose both bills. With respect to S.B. 513, the offending language was deleted in the bill passed by the Senate, and the bill was tabled in the House tax committee, leaving the bill effectively dead for the last legislative session. Similarly, S.B. 521 also was tabled by the House tax committee, again leaving it effectively dead for the last legislative session. NAREIT is not aware of any indications that similar legislation would be introduced in Montana in the next legislative session (which will begin in two years). With that said, the current head of the Montana Department of Revenue formerly was head of the Multistate Tax Commission, and appears to have concerns regarding the state tax treatment of REITs. Accordingly, with the help of its members with Montana properties, NAREIT will continue to monitor legislative developments in Montana.

F. South Carolina Legislation Would Have Disallowed DPD for Private REITs

During the 2005 South Carolina legislative session, Rep. Herb Kirsh (D) introduced an amendment to H 3767, which, among other things, would have disallowed a DPD for non-publicly traded REITs. This bill also included a provision that stated that income generated from real estate contributed or sold to a REIT by a shareholder or related party could not give rise to a DPD unless the shareholder or related party would have received the DPD itself under South Carolina law. Rep. Kirsh apparently deleted these two provisions concerning REITs from the bill following opposition from a number of groups, including the banking industry. NAREIT also contacted Rep. Kirsh to discuss NAREIT's opposition to such a proposal, and Rep. Kirsh indicated that the proposal would remain deleted from the bill.

NAREIT is not aware of any indications that similar legislation would be introduced in South Carolina next year. Nevertheless, NAREIT will continue to monitor legislative developments in South Carolina.

III. Taxation of Transfers of "Controlling Interests" in Real Estate Entities Considered (Maryland and Massachusetts)

A. Maryland: "Controlling Interest" Legislation Proposed, Not Enacted

The previous Maryland legislative session also included a proposal that has surfaced every year for the past four years, and has been defeated following significant opposition by the real estate industry, H.B. 1, which would have imposed Maryland transfer and recordation taxes on transfers of controlling interests in entities that hold primarily Maryland real estate. As in the past, NAREIT worked with former CEO of Mid-Atlantic Realty Trust, Pat Hughes, the Maryland Chamber of Commerce, as well as a number of other real estate organizations, to defeat this legislation. H.B. 1 passed in the House but died in the Senate. It would not be surprising for a similar bill once again to be introduced in the 2006 legislative session, and NAREIT will continue to monitor legislative developments in Maryland with the goal of opposing the enactment of such legislation.

B. Massachusetts: Legislation Pending

Legislation has passed both the Massachusetts House of Representatives and Senate that would extend the Massachusetts "deed tax" generally to the transfer of an interest in an entity that owned primarily real estate. On July 14th, the Senate passed its version of this bill, S.B. 2092. The Senate's bill was slightly different from the version the House passed (in June), H.B. 4169 (link not available).

In general, the House bill is more expansive and applies to transfers of interests in all entities holding real estate, while the Senate bill is directed at more abusive transactions in that it only applies to transfers of entities if the fair market value of the property represents 80% or more of the value of the company. In other words, the Senate version targets transfers of special purpose real estate entities. They have different effective dates too, among other things.

There are currently no exemptions other than pledges as collateral or conveyances of publicly traded interests. The General Counsel of the Massachusetts Department of Revenue (DOR) has indicated that the tax will still be based on consideration, so true gifts, etc. and transfers without consideration should be exempt. It is rumored that the DOR will likely look to the New York rules for guidance, and DOR representatives have told at least one NAREIT member that it will be looking to the real estate community for help drafting regulations if the legislation passes.

The two bills, both of which contain provisions unrelated to the controlling interest issue, now go to conference committee, which will attempt to reach an agreement on a final bill. We understand that while the conference committee may reach an agreement in August, it is more likely to do so in September.

NAREIT is concerned about two potential applications of the controlling interest deed tax, and is considering a legislative initiative to oppose, or at least modify the current versions of the legislation while it is being considered by the conference committee. The two concerns are as follows. First, NAREIT is concerned that the legislation could affect adversely the merger of a publicly traded REIT with another entity to the extent lower-tier entities (or even the REIT) owned properties in Massachusetts. Second,

NAREIT is also concerned that the proposed legislation could have a "chilling" effect on UPREIT transactions, that is, transfers of partnership interests in real estate partnerships to operating partnerships in exchange for partnership units in a transaction that is tax-deferred for federal income tax purposes. Please let Dara Bernstein know at dbernstein@nareit.com if your company would be interested in opposing this legislation.

IV. Real Estate Transfer Tax Changes (Minnesota and Virginia)

NAREIT thanks Joseph Gurney of Deloitte & Touche LLP in Chicago for the following submission.

A. Minnesota Tax Legislation Affects Transfers of Interests in Real Estate Entities

House Bill 138 (H.F. 138), the Minnesota legislature's Omnibus Tax Bill, was signed by Governor Tim Pawlenty (R) on July 13, 2005. The bill contains several property, income and franchise, sales and use, deed, and other tax changes, as well as adding tax shelter provisions. Among the more significant developments for the real estate industry are the deeds tax changes that can impose the deeds tax on certain transfers of interests in entities, as described below.

Effective July 14, 2005, H.F. 138 amends the deed tax to clarify the definition of consideration and to provide guidance on the application of the tax to transfers of property where there is no change in the beneficial ownership of the property. Consideration is assumed to equal the fair market value of the property when the consideration includes payment of something other than money or the promise of money. Only the $1.65 minimum deed tax applies to transactions which involve legal ownership changes, but no change in the underlying beneficial ownership of the real property. Additionally, the deed tax does not apply to conversions of one type of entity to another.

Application to Transfers of Interests in Entities That Own Real Estate

However, in order to address a perceived potential abuse of the new beneficial ownership rules, the deed tax applies to subsequent transfers of an ownership interest in an entity which received property in a transaction that was only subject to the minimum deed tax. Specifically, when a property is originally transferred in a transaction with no change in beneficial ownership, and, within six months of the transfer, an ownership interest in the grantee entity is transferred which results in a change in the underlying beneficial ownership of the grantee's property, the deed tax applies to the original transfer. If the subsequent transfer was reasonably expected at the time of the original transfer, a penalty for failure to pay the full amount of the tax applies.

B. Virginia Deed Recordation Tax Legislation Enacted: Also Would Impose Recordation Tax on Certain Transfers of Interests in Entities

House Bill 2177 (H.B. 2177), the Legislature's response to an apparent abuse of the recordation tax involving the conveyance of real property to a newly organized entity followed by the sale of the entity's ownership interest rather than a direct sale of the real property, was signed by Governor Mark Warner (D) on March 20, 2005. Under Virginia law, a recordation tax is imposed on the transfer of title to real property upon the

recording of a deed. The recordation tax does not apply to transfers of real property which do not involve the recording of a deed, such as when an interest in an entity such as a partnership or limited liability company (LLC) is transferred.

Effective July 1, 2005, the recordation tax exemption statute is modified to remove the exemption for any transfer of real property to or from a LLC that is a precursor to a transfer of control of the LLC's assets with the intent to avoid recordation taxes. Although the text of H.B. 2177 does not provide for a similar restriction on the exemption for transfers to or from a partnership, the Division of Taxation's impact statement on the bill indicates that it intended to apply the same restriction to such transfers.

V. Pass-Through Entity Withholding Developments Potentially Concerning REITs (Arkansas and Maryland)

A. Arkansas: Pass-Through Entity Withholding Enacted/REITs Generally Not Affected

Arkansas recently enacted a pass-through entity withholding statute, known as Act 1982 (S.B. 509). Although in general "pass-through entities" now will be required to withhold the highest rate of Arkansas income tax (7%) from their non-resident members, it appears that REITs are neither considered "pass-through entities" that are required to withhold nor members of pass-through entities that are subject to the withholding. New Arkansas Code § 26-51-918(a)(4) defines a "pass-through entity" as an S corporation, general or limited partnership, limited liability partnership, LLC or trust that is not taxed as corporation for federal income tax purposes. Corporations and trusts taxed as corporations for federal income tax purposes thus are specifically excluded from the definition of pass-through entities. As a result, neither corporate nor business trust REITs should be required to withhold the 7% Arkansas tax.

Furthermore, new § 26-51-918(b)(1)(A) requires withholding on amounts distributed to each "nonresident member." However, new § 26-51-918(a)(2)(B) excludes from the definition of "member" a "Subchapter C corporation as defined in Internal Revenue Code § 1361(a)." Section 1361(a) defines a "Subchapter C corporation" as "a corporation which is not an S corporation for such year." Clearly, a corporate REIT would be a corporation that is not an S corporation. Most likely, a business trust REIT, because it is taxed as a corporation for federal income tax purposes, similarly would be considered a "corporation," which, without a doubt, is not an S corporation.

As a result, it appears that a REIT should not be considered a member subject to withholding for Arkansas tax purposes, *e.g.*, when an Operating Partnership distributes income to the REIT in an UPREIT structure. A similar analysis should apply to QRSs that own pass-through entity interests; they also should be considered corporations that are not S corporations (to the extent that Arkansas does not disregard their existence entirely). We note that a NAREIT member has confirmed this analysis with the Arkansas tax authorities.

B. Maryland: Pass-Through Entity Withholding Statute Modified/REITs Not Subject to Withholding

The budget bill of the 2005 Maryland legislative session would have required partnerships to withhold Maryland tax on distributions to REIT partners even though those REITs were unlikely

to have had any Maryland tax liability. NAREIT worked with a Maryland consultant to modify H.B. 147 to exempt partnerships from having to withhold on distributions to REITs or qualified REIT subsidiaries. Under the legislative language that was eventually enacted, partnership distributions to REIT and qualified REIT subsidiary partners are not subject to Maryland withholding tax. See page 46 of the bill associated with the following link for the legislative language.

VI. Massachusetts: Legislation Pending To Reduce Many REITs and Affiliates' Tax Liability

A. Change in Measure of Net Worth Portion of Corporate Excise Tax

As discussed in more detail in our January 2005 SALT Policy Bulletin, last summer, the Massachusetts legislature changed the formula for calculating the "non-income" (net worth) measure of the Massachusetts corporate excise tax (known in Massachusetts as the "corporate excise"). Prior to this change, taxpayers could determine the non-income measure using either a "domestic" or "foreign" calculation, whichever yielded a better result. The legislative change requires all corporations to use the domestic calculation, effective for all tax years ending on or after Aug. 9, 2004. The unintended result of this legislation was a dramatic increase in the Massachusetts net worth tax liability of many real estate companies, especially those with significant property holdings outside of Massachusetts.

At the request of an affected company, NAREIT assisted in organizing a coalition of similarly affected REITs to fund a legislative initiative and hire a consultant to seek a modification to last summer's legislative change. As a result of these efforts, legislative provisions were drafted to require REITs that are required to file public documents with the SEC under the 1934 Securities and Exchange Act (that is, REITs that are publicly registered) to use the old "foreign" calculation for calculating net worth.

This language, in identical form, has been included in bills that have passed both the House (link not available) and the Senate. (These are the same bills discussed in section III. B. above concerning the proposed "controlling interest" legislation). The bills also contain differing versions of other provisions that are not relevant to REITs. The bills are now before a conference committee comprised both of House and Senate members that will attempt to reconcile all differing provisions of the bill. Because the REIT language is the same in both the House and Senate versions, it cannot be changed by the conference committee. The Massachusetts legislature is not in formal session during August although, apparently, the conference committee is meeting in an attempt to reach an agreement on the bills.

We are advised that while an agreement is possible in August, it is more likely to be in September when the legislature again begins a formal legislative session. Because the REIT language cannot be changed by the conference committee, we are advised that as long as the conference committee can reconcile other provisions of the bills, the REIT provisions will be enacted unless the governor vetoes the entire bill. A veto is not considered likely. We will keep you informed of further developments.

B. Proposal to Conform to Federal Choice of Entity Rules Not Expected in 2005

Our January 2005 SALT Policy Bulletin discussed a proposal being urged by Massachusetts DOR to conform the Massachusetts choice of entity rules to the federal choice of entity rules. The bulletin also discussed the potentially adverse consequences of such conformity for some REITs. A conformity provision is included in S.B. 2092 (discussed in section III.B. and VI.A. above) but not in the corresponding House bill. Because it is not clear whether the House will agree to this provision, enactment of conformity legislation this year is uncertain at best.

VII. California

A. Split Roll Tax Proposal Suspended, But Expected in 2006

In our January 2005 SALT Policy Bulletin we discussed a California bill, S.B. 17, that would have modified the property tax treatment of commercial property. (It is known as a "split roll" proposal because it splits the property tax rolls between commercial and residential properties.) As drafted, S.B. 17 would have applied a number of onerous provisions to real estate companies, and, in particular, to publicly traded real estate companies. In addition to S.B. 17, a number of taxpayer-initiated split roll tax proposals had been filed with the California Attorney General's office.

Update

Since our last SALT Bulletin, the sponsor of S.B. 17 has withdrawn the bill, and the bill is now being held in suspense. We are advised to expect a similar bill in 2006. Furthermore, at least one taxpayer initiative discussed in the last SALT Bulletin has been abandoned, and others have been delayed until at least 2006.

B. Conformity Bill Pending/Could Affect REIT Issues Other Than REIT Qualification

Background

In general, California's Revenue and Taxation Code (RTC) does not conform automatically to changes made to the Internal Revenue Code. RTC § 17024.5 only conforms to the Internal Revenue Code as of Jan. 1, 2001. In fact, following the enactment of the REIT Modernization Act (RMA) in 1999, NAREIT worked with California policymakers to modify the RTC so that a REIT that qualified in a particular taxable year as a REIT for federal purposes would be qualified as a REIT for California purposes. Thus, California automatically conforms to further federal changes to the REIT qualification provisions. The automatic conformity provision is contained in RTC § 24872.6. RTC § 24872(h) also states that the provisions of the RMA relating to taxable REIT subsidiaries shall apply unless otherwise provided.

REIT Improvement Act/Issues Other Than REIT Qualification

As many of you know, Congress enacted the REIT Improvement Act (RIA) as part of the American Jobs Creation Act of 2004 in October 2004. Click here for the statutory language of the RIA. The RIA contained three titles: one relating to technical issues with respect to the REIT asset tests and other issues under the RMA; one relating to withholding on REIT dividends to foreign investors; and one allowing REITs to retain their status for certain non-intentional violations of the REIT rules in certain cases.

Some of the provisions of the RIA relate to issues other than REIT qualification. For example, there is a provision that allows a REIT to consider as qualifying rental income certain rental income from a taxable REIT subsidiary even though that income might have been non-qualifying income prior to the enactment of the RIA. Treatment as non-qualifying income would not necessarily have caused the termination of the REIT's status as a REIT.

Conformity Bill Proposed

Assemblymember Johan Klehs (D), Chair of the Assembly Committee on Revenue & Taxation, has proposed A.B. 115, a bill that would generally conform California personal income and corporation tax laws to federal income tax laws as set forth in IRC as of Jan. 1, 2005, with limited exceptions. One of the legislative analyses of this bill specifically states it "conforms to numerous provisions of the American Jobs Creation Act of 2004 . . . specifically includ[ing] . . [m]iscellaneous technical and administrative provisions . . . dealing with . . . real estate investment trusts." The bill also would delete RTC § 24872(h)'s statement that the provisions of the RMA relating to taxable REIT subsidiaries shall apply unless otherwise provided, presumably because they already apply through the conformity to the IRC.

Our understanding, following a conversation with a representative of the Franchise Tax Board, is that this bill would conform to the IRC as of Jan. 1, 2005, with respect to issues other than REIT qualification. REIT qualification would continue to be governed by RTC § 24872.6.

The Revenue & Taxation Committee held a hearing on the bill on June 30, 2005. Another hearing is expected on the bill, but it has not yet been scheduled.

VIII. Florida Supreme Court Limits Property Tax Reassessments to When Property is "Substantially Complete"

By way of background, Florida imposes its property tax only on the value of the land while the property is in the process of being developed (for example, while a shopping mall is being built). Only when the improvements are "substantially complete" are the building and its improvements then subject to property tax.

This rule is obviously important to REITs and other property owners because it may take a significant amount of time to develop a particular piece of property. Not only does this significantly lower the cost of development, it also takes a major area of dispute off the table. The value of land typically is not too much of a challenge. There is often a recent purchase price and plenty of comparables to consider. However, the issue of the value of a partially complete project is highly subjective and rarely occurs in the market. If a partially complete project does sell, it is likely to be distressed. REITs typically would argue that "value" must reflect a discount to cost, while the assessor would argue that value is greater than cost. In states without a similar statute, REITs can spend years litigating this question.

In the case of Sunset Harbour v. Robbins, an assessor had challenged the constitutionality of the "substantial completion" statute. NAREIT had joined other interested parties in filing an *amicus curiae* brief in support of this statute against the assessor's challenge. (NAREIT had also filed an *amicus* brief in a related case, Fuchs v. Robbins, which the Florida Supreme Court ultimately dismissed for lack of standing.)
In Sunset Harbour, the Florida Supreme Court ruled against the assessor and found that the statute governing the assessment of partially

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complete improvements was constitutional. As a result of this decision, Florida property taxes will continue to be assessed on land only until improvements are substantially complete.

IX. New York's 2005-06 Budget Did Not Eliminate the Dividends Received Deduction Or Deny a Deduction for Rent Paid to a Closely Held REIT

In our last Bulletin, we stated that Governor George Pataki (R-NY) released a proposed state budget for fiscal year 2005-06, which contained provisions that could have denied: (1) a shareholder of a REIT a dividends received deduction with respect to REIT dividends (which is the same rule for federal purposes); and, (2) a deduction for rent paid to a "closely held" REIT (a REIT more than 50% owned by the tenant). We have been advised that neither provision was contained in the actual budget enacted by the New York legislature.

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

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