Introduction

This is the second 2008 issue of NAREIT’s State and Local Tax Policy Bulletin. As has been the case in the past, a number of the state legislative developments described below concern state attempts to limit the use of “captive REITs,” in most cases by eliminating the dividends paid deduction (DPD) of such entities. (See the January 2008 SALT Policy Bulletin for more details.) NAREIT carefully monitors developments in this area and, if necessary, suggests appropriate modifications to prevent adverse effects to legitimately operating REITs.

Set forth below is a brief summary of captive REIT developments in the following states: Georgia, Illinois, Iowa, Massachusetts, New York, Oklahoma, Tennessee, Utah, Virginia, West Virginia, and Wisconsin. In addition to the captive REIT developments, we understand that some California localities are imposing transfer tax liability on transfers of controlling interests in real estate-owning entities notwithstanding the absence of statutory authority to do so. Finally, the Maine Legislature’s Joint Standing Committee on Taxation recently voted against a bill that would have imposed a special capital gains tax on REITs.

Captive REIT Developments

Thanks to Jane Steinmetz of PricewaterhouseCoopers LLP for alerting us to the following:

Georgia

Last week, the Georgia House of Representatives passed H.B. 447 concerning “captive REITs.” The bill is now before the Georgia Senate Finance Committee. Unlike other state captive REIT bills, this bill would disallow a dividends received deduction (DRD) with respect to any dividends received directly or indirectly from any REIT (not just a “captive REIT”). Furthermore, the bill would require an add-back to taxable income for any amount deducted in arriving at federal taxable income to the extent such deduction is attributable to a dividend received directly or indirectly from any REIT (again, not just a captive REIT). Finally, the bill would require a Georgia taxpayer to “add back all expenses and costs directly or indirectly paid, accrued, or incurred to a captive real estate investment trust.”

A “captive real estate investment trust” would be defined as a non-listed REIT if more than 50% is owned or controlled, directly or indirectly, through one or more related members, by a single C taxable corporation that is not a REIT or qualified REIT subsidiary. This definition appears to be based...
on Louisiana’s 2005 captive REIT legislation, rather than the draft REIT statute approved by the Multistate Tax Commission (MTC) Executive Committee in January 2008. For more details, see the January 2008 SALT Policy Bulletin. Non-listed REITs owned by listed Australian property trusts potentially could be considered “captive REITs” under the proposal.

The bill also provides that the add-back of expenses to a captive REIT should be reduced, but not below zero, to the extent the corresponding expenses and costs are received as income in an arm’s length transaction by the captive real estate investment trust and, additionally:

(A) To the extent such income is not reduced by the dividends paid deduction; and to the extent such income is allocated or apportioned, or both, to and taxed by Georgia or another state that imposes a tax on or measured by the income of the captive real estate investment trust; or
(B) To the extent the dividend deriving from such income, paid directly or indirectly by the captive real estate investment trust to the taxpayer or a related member, is allocated or apportioned, or both, to and taxed by Georgia or another state that imposes a tax on or measured by the income of the taxpayer or such related member.

Section 3 of H.B. 447 (proposing new section 48-7-28(d)(2)).

NAREIT is in the process of analyzing the proposal and will respond appropriately. Please contact Dara Bernstein at dbernstein@nareit.com if you have any comments with respect to this legislation.

Illinois

Last year Illinois enacted two bills that limited the DPD of “captive REITs.” The first bill was S.B. 1544, which was followed by a “trailer bill” that included “technical corrections,” S.B. 783. Unlike S.B. 1544, S.B. 783 treats a REIT as a captive REIT if it is more than 50% owned by a “person.” The term “person” includes not only a corporate entity, but also a partnership. A REIT more than 50% owned by another REIT, listed Australian property trust (LAPT) or tax-exempt organization would not be viewed as a captive, but a REIT more than 50% owned by a partnership, equally owned by these “qualifying” entities, would be viewed as a captive.

NAREIT has been working through a local advocacy group to educate policymakers that the change to S.B. 1544 from S.B. 783 could affect legitimately formed REITs. In part as a result of these efforts, on February 15, 2008, Senator Tom Harmon (D) introduced S.B. 2643, which would conform Illinois’ captive REIT statute to the draft proposed by the MTC. Most importantly, it would treat a non-listed REIT as a captive only if the REIT were more than 50% owned by a corporation (other than another non-captive REIT, listed Australian property trust or tax-exempt organization).

Additionally, S.B. 2643 would permit a foreign REIT (as specifically defined in the legislation) to own more than 50% of a non-listed U.S. REIT without the U.S. REIT being viewed as a captive. NAREIT is currently engaged in a dialogue with the Illinois Department of Revenue concerning the provisions of S.B. 2643. The Department of
Revenue continues to believe that there are potentially abusive situations in which a partnership or other non-corporate entity could own a private REIT. NAREIT hopes to reach a favorable compromise with the Department of Revenue shortly.

**Massachusetts**

As reported in the last *SALT Policy Bulletin*, a tax study commission in Massachusetts recently issued a final report recommending, among other things, that Massachusetts adopt combined reporting and conform its entity classification rules to the federal check-the-box rules. It is thought that the adoption of a comprehensive combined reporting structure would eliminate the use of “captive REITs,” as well as other “schemes,” that inappropriately reduce state income tax liability.

Furthermore, the entity classification change could result in additional tax liability for entities formed as business trusts, rather than corporations. Under current Massachusetts rules, for example, a business trust REIT is exempt from the Massachusetts net worth and excise tax, while a corporate REIT is not. See the [July 2005](http://www.realestatejournal.com/reits/20070205-drucker.html?refresh=on) for a diagram of this structure.

Under H.B. 4499, Massachusetts would adopt a water’s edge approach so that a REIT would not be required to file a combined return with a foreign owner if such owner or its unitary affiliate is taxable in Massachusetts, irrespective regardless of whether the REIT has nexus with the state. A REIT’s DPD would not be disallowed; however, the owner’s DRD for dividends received both directly and indirectly from a REIT are disallowed under current law. Thus, it would not be possible to interpose a holding company, insurance company, etc. between the REIT’s majority holder and the REIT as is the case in the “typical” captive REIT structure.1

1 Absent such a rule, in the typical structure, the parent receives a rent deduction for rent paid to the REIT; the REIT receives a DPD for dividends distributed to a holding company or other entity; then when the holding company or other entity distributes the dividends back to the ultimate parent, the ultimate parent also receives a DRD since the dividend is not directly from a REIT. See [http://www.realestatejournal.com/reits/20070205-drucker.html?refresh=on](http://www.realestatejournal.com/reits/20070205-drucker.html?refresh=on)
majority owner. The bill also would provide the Massachusetts Commissioner of Revenue discretion to include in the unitary group any entity deemed to have a unitary relationship with the group whenever necessary to prevent avoidance of taxes. NAREIT is continuing to analyze the bill for further details.

New York

By way of background, last year, New York enacted legislation requiring a “captive REIT” to file a combined return with its majority owner, pursuant to which it would not be entitled to a DPD. The legislation also requires combined filing by REITs that had significant intercompany transactions with their taxable REIT subsidiaries (TRSs) or qualified REIT subsidiaries (QRSs). See the July 2007 State and Local Tax Policy Bulletin for more details.

Apparently believing that the potential for abuse still exists with respect to “captive REITs,” on January 22, 2008, ex-Governor Eliot Spitzer (D) proposed an Executive Budget that would make certain changes to these captive REIT rules. S.6810 proposes changes to last year’s New York legislation that would, among other things, limit the use of “captive REITs” even more. Under the proposal, a captive REIT would be defined as "a REIT that is not regularly traded on an established securities market, and more than 50% of the voting stock of which is owned or controlled, directly or indirectly, by a single corporation that is not exempt from federal income tax and is not a REIT."

Although REITs owned by LAPTs would not have been considered “captive REITs” under the 2007 legislation (because the LAPTs were not a New York taxpayers in general), under the 2008 proposal, an LAPT-owned REIT would meet the definition of a captive REIT if the LAPT owned more than 50% of the REIT. Thus, if the LAPT-owned REIT filed on a combined basis with TRSs or QRSs, then it would lose the REIT DPD. It is also possible that the LAPT-owned REIT could be subject to the New York "capital" tax (with respect to which REITs are typically exempt).

A number of affected NAREIT members are attempting to seek a modification of this proposal so that certain foreign-owned REITs would not be considered “captive REITs” and so that the more than 50% foreign owner of a REIT that is not otherwise included in the combined return should not be included in a combined return of a REIT.

Oklahoma

Governor Brad Henry’s Fiscal Year 2009 Budget dated February 4, 2008 includes the following statement concerning changing the taxation of REITs in Oklahoma:

Closure of Corporate Tax Loophole- The Governor is proposing to close a tax loophole that allows certain income to completely escape state taxation. In cases in which a corporation owns a controlling interest in a Real Estate Investment Trust (REIT), Oklahoma automatically passes through the federal “dividend paid deduction” allowing the REIT to avoid state taxation. At the Federal level, the distributed REIT income is taxed when the REIT owners are taxed. This does not occur at the state level and, thus, the income is never taxed at the state level. Simply removing the deduction from the Oklahoma tax code would restore fairness to Oklahoma’s tax system and raise $6.0 million in FY-2009.

(Emphasis added).

While this statement appears to indicate the governor’s plan to eliminate the DPD for all REITs, officials from the governor’s administration have indicated to NAREIT...
representatives that the governor’s plan is to only change the taxation of “captive REITs.” We are not aware of the introduction of any legislation that would implement the governor’s budget proposal on his behalf.

Separately, however, Senator Jim Wilson (D) introduced S.B. 1827, which would treat a REIT as a captive REIT only if it is owned by more than 50% by another corporation other than a captive REIT. S.B. 1827 would treat a listed Australian property trust-owned REIT as a captive REIT. NAREIT has recommended to Senator Wilson and to Governor Henry’s tax policy representative that this language be broadened to permit such ownership without resulting in captive REIT status. NAREIT continues to monitor developments in Oklahoma.

Tennessee

As you may recall, in 2006, Tennessee modified its partnership-level tax rules to no longer exempt REIT-owned partnerships from the Tennessee corporate franchise tax to the extent of REIT ownership in the partnership. However, despite earlier proposals by the Tennessee Department of Revenue (TDOR) to adopt a similar rule for the Tennessee excise (net income) tax, following advocacy by consultants engaged by a NAREIT tax coalition, the Tennessee Department of Revenue (TDOR) agreed to continue essentially exempting REIT-owned partnerships from the Tennessee corporate excise tax to the extent of REIT ownership. See the June 2006 SALT Policy Bulletin for more details.

Following public comments by TDOR Commissioner Regan Farr late 2007 concerning a proposal that might address closing a “REIT loophole,” NAREIT became concerned that TDOR was considering revoking its earlier agreement. Accordingly, NAREIT re-engaged some of its lobbyists from the 2006 matter to look further into the TDOR’s intentions. While no legislative language addressing REITs has been proposed, certain sources have indicated that TDOR’s targets are captive REITs, not REIT-owned partnerships. With the help of its lobbyists, NAREIT will continue to monitor and respond to legislative developments in Tennessee.

Utah

In Utah, a captive REIT bill, S.B. 204, has passed the Utah Senate and is pending in the House. Although NAREIT had agreed with the Utah Tax Commission on language that essentially mirrored the MTC draft language, the original version of S.B. 204 contained modifications to that language that could have resulted in certain legitimately-formed REITs’ being viewed as captive REITs. Following NAREIT’s suggestions of certain changes to the original language, the sponsor of S.B. 204 amended the bill so that it largely, but not completely, follows the MTC draft captive REIT language. It does permit listed Australian property trusts to own non-listed U.S. REITs without those REITs being viewed as captive REITs.

Virginia

After associations representing retail merchants and the banking industry testified before a Virginia legislature tax subcommittee in opposition to a NAREIT-backed captive REIT bill introduced in January 2008 by Del. Steve Shannon (D), the bill died in subcommittee.

Shannon’s proposal essentially mirrored the MTC draft of a uniform captive REIT statute circulated by the Multistate Tax Commission (MTC), a coalition of state governments. The bill, H.B. 975, would have required captive REITs—defined as when the majority of a REIT is owned by a taxable corporation—to add their DPD to their taxable Virginia state income. “Taxable corporations” would have excluded a non-captive REIT; a qualified REIT subsidiary of a non-
captive REIT; a Listed Australian Property Trust or trust more than 75% owned by a Listed Australian Property Trust; and a “qualified foreign entity.”

The introduction of Shannon’s bill followed a recent dialogue between NAREIT and the Virginia Department of Revenue over captive REITs, in which state authorities agreed to largely follow the MTC’s draft statute. NAREIT provided commentary and recommendations to the MTC as it was formulating its draft statute.

**West Virginia**

At the end of March 2008, West Virginia enacted H.B. 4420, which provides that only a qualified REIT (that is, a non-“captive” REIT) will receive a DPD for West Virginia state income tax purposes. For this purpose, H.B. 4420 defines a qualified REIT as any “any real estate invest trust”[sic], including a publicly traded REIT, if no single taxable C corporation (other than a REIT or qualified REIT subsidiary) owns or controls, directly or indirectly, constructively or otherwise, fifty percent or more of the voting power or value of the “real estate invest trust”[sic]. NAREIT had suggested to the sponsors of H.B. 4420 that they conform their statute to the MTC’s draft captive REIT statute, but the sponsors apparently declined to do so.

**Wisconsin**

A bill to limit the use of “captive REITs,” S.B. 527, was introduced earlier this year. However, the legislature failed to address the bill in a timely manner. NAREIT and the Property Council of Australia (representing the listed Australian property trust industry) have engaged a consultant to interact with Wisconsin policymakers so that, if Wisconsin does address captive REITs, its legislation is not adverse to NAREIT members.

Separately, however, Governor Jim Doyle (D) has included a captive REIT provision in his “budget repair bill,” and this provision is expected to be part of the “budget repair bill” (LRB 4268) that will be introduced shortly. NAREIT will continue to monitor and respond to developments.

NAREIT thanks Sam Melehani and Anna Hoti of PricewaterhouseCoopers LLP for the following submission.

**Other Developments**

**California Cities and Counties Impose Transfer Taxes on Owned Real Property in Some Equity Acquisitions**

Generally, it has long been understood that California counties and cities generally impose a tax on a deed or other instruments by which property is transferred as well as property held by a partnership that is deemed to technically terminate under IRC § 708. Some California counties and cities, however, are beginning to impose transfer taxes on the acquisition of a controlling interest in entities (corporate and non-corporate entities) that own California property located within their borders. The counties and cities are assessing the tax on current and past transactions under which a transfer of an ownership interest in an entity results in a “change in control” or a “change in ownership” under state property tax law.

The cities and counties that have imposed the taxes on the basis of a transfer of a controlling
interest are primarily Charter Law municipalities, including Los Angeles, and many counties in the San Francisco Bay area. This change follows a change in terminology by some courts that describe the tax as a “real property transfer tax” rather than a documentary transfer tax.

Recently, the City/County of San Francisco has been identifying unrecorded transactions that appear to represent a re-appraisable event for property tax assessment and asserting that a transfer tax would also be applicable.2 Los Angeles and San Mateo counties also have been taking a similar approach.

In response to this recent audit activity, in September 2007, Santa Clara County modified its transfer tax ordinance.3 As modified, the ordinance specifically imposes real property transfer taxes when a transaction involving equity ownership in a legal entity resulted in a “change in control” or a “change in ownership” for real property reassessment purposes under California’s Proposition 13 base year value system.4 The ordinance seems to be retroactive in its application as currently written. However, we are not aware of any instances where the county has pursued these taxes on a retroactive basis.

Maine

By way of background, on Dec. 21, 2007, Representative Robert Duschesne (D) introduced L.D. 2074, which would have imposed a corporate level tax on REIT capital gains. L.D. 2074 is modeled after a similar bill introduced last year in Montana that NAREIT successfully opposed with the assistance of several members. As a result, NAREIT organized a group of more than 10

members with Maine properties to oppose this legislation. Additionally, NAREIT engaged a number of political and other consultants to assist with this effort.

On February 5, 2008, Maine’s Joint Standing Committee on Taxation held a hearing on L.D. 2074 at which Steve Rice and Joe Johnson of CNL Income Properties, Inc. (CNL) testified. CNL purchased two ski resorts in Maine in late 2007 and has contributed significant funds towards their improvement over the last few months.

On March 5, 2008, the Maine Legislature’s Joint Standing Committee on Taxation held a “work session” on L.D. 2074, during which the bill’s sponsor proposed an amendment to the bill’s original language. The amendment contained a resolution requiring Maine Revenue Service (the Maine equivalent of a department of revenue) to form a “study committee” to evaluate a variety of issues relating to REITs, including transactions between REITs and TRSs and “captive REITs” and report back in January 2009.

Ultimately, this amendment failed, but the Committee did agree unanimously to vote against the bill and send a letter to the Maine Revenue Service asking them to study these issues and report back to the legislature in January 2009. We have been advised that the potential impact of this type of requesting a study pursuant to this type of letter is considerably less significant than a formal study committee. We anticipate that Maine Revenue Service will request input from interested

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2 San Francisco Chronicle, Tuesday, June 19, 2007
3 Chapter III, in its entirety, of Title A of the Ordinance Code, County of Santa Clara, California
4 Part 0.5, commencing and ending with Section 64 of Division 1 of the Revenue and Taxation Code
parties like NAREIT and the Maine Forest Products Council. We consider this resolution positive because it avoided an unpredictable floor fight on the bill and also offers us the opportunity to provide information supportive of our position to Maine Revenue Service.

NAREIT appreciates the efforts of Steve Rice and Joe Johnson from CNL Income Properties, who testified against L.D. 2074 during the first committee hearing. It was clear during the work session that the testimony about the value REITs can provide to a local community was influential to a number of legislators’ final decisions.

For further information, please contact Dara Bernstein, dbernstein@nareit.com

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