

CAPTIVE REITs

Captive REITs and State Income Tax Avoidance

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What is a REIT?

- **Creature of the Internal Revenue Code. IRC Sec 856 -860**
- **Name suggest trust? But REIT can be a corporation – does not have to be a trust.**
- **Must meet IRC criteria and make federal election**
 - ▣ **IRC Criteria = certain percentage of assets and income must be real estate related**
 - **Assets can be real estate backed securities – mortgages – GNMA and FNMA**
 - **Must Dividend out 90 + % of its income**
- **Federal tax treatment of REITs = flow through treatment**
- **Flow through treatment accomplished through DPD**
- **REIT is similar to a RIC which = mutual fund**

Captive REITs – Two Types

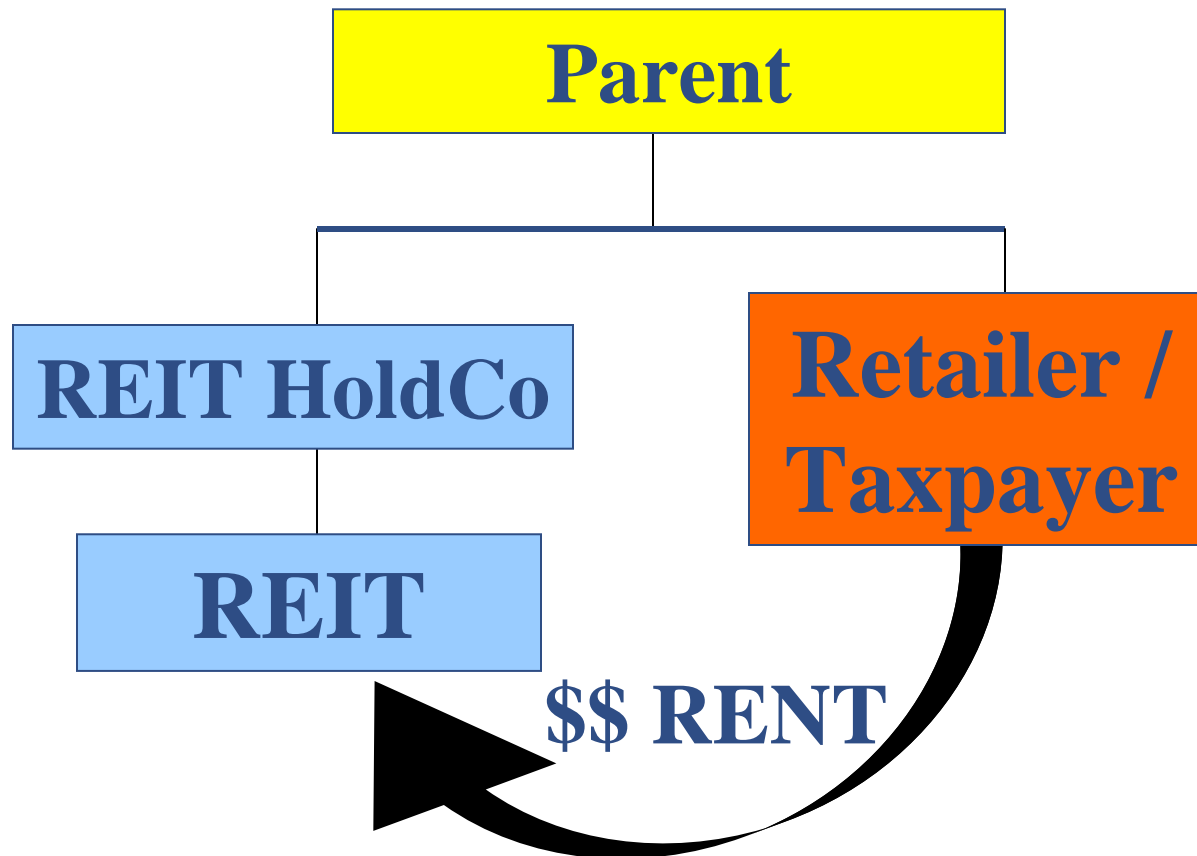
Type One – Rental REIT

- Common to large multi-state retailers
- REIT holds real property directly
- In-state operating company / taxpayer shifts income to REIT through rent expense payments
- REIT files state income tax return, but shelters income with the dividends paid deduction (DPD)

Type Two – Mortgage REIT

- Common to the multi-state banking industry
- REIT holds mortgages or mortgage backed securities
- Mortgage interest that used to accrue at the in-state bank / taxpayer now accrues at the REIT
- REIT may or may not file state income tax return – if so it shelters income with the dividends paid deduction (DPD)

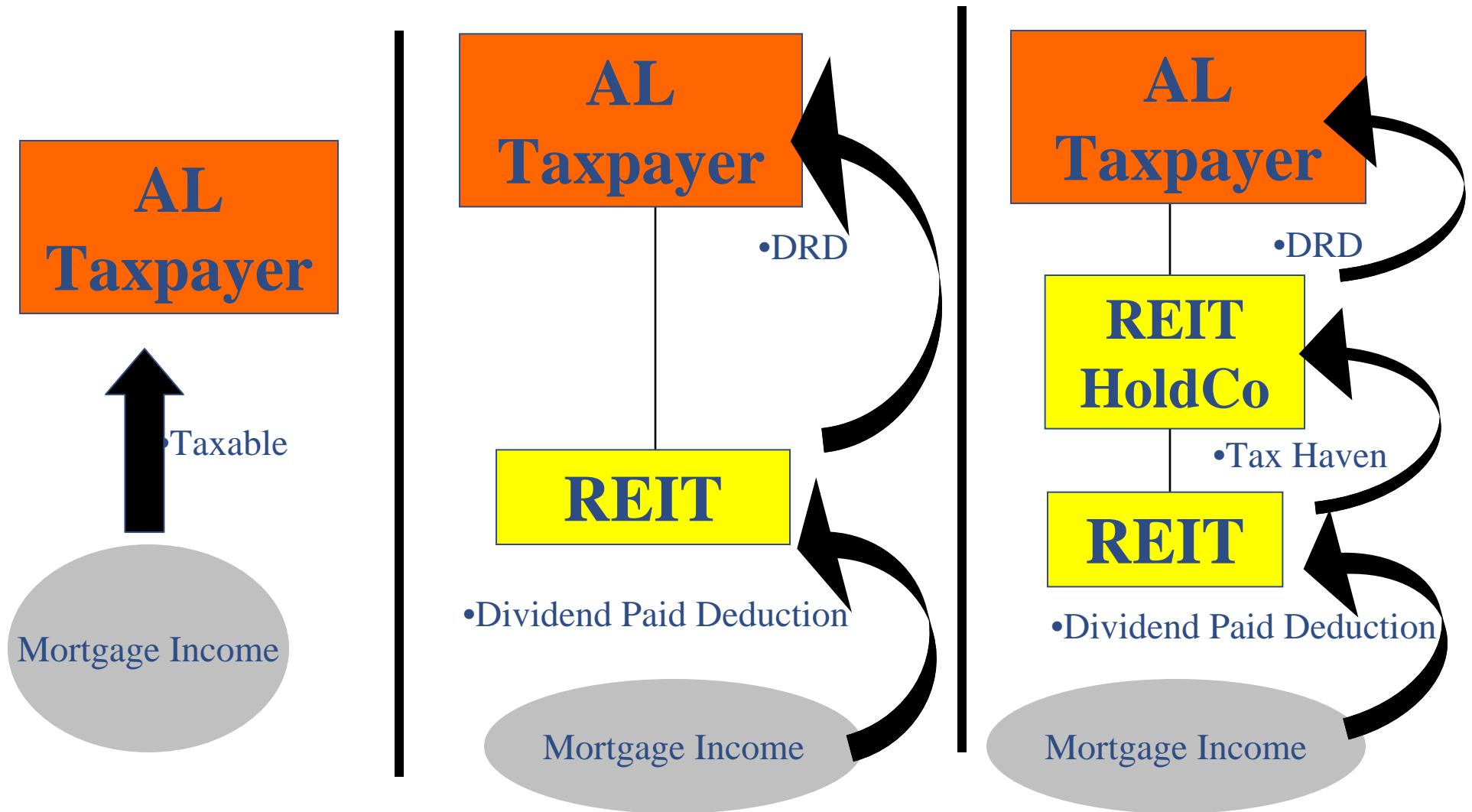
Captive REIT – Rental REIT Structure



- The REIT ostensibly “owns” store locations used by Retailer.
- Retailer shifts income to REIT through rental payments.
- REIT avoids state income tax liability b/c of the dividends paid deduction for REITS.

•REIT HoldCo avoids tax on the dividend b/c it is located in a state that allows a DRD, a no tax state, or a combined return state where the dividend is eliminated.

Captive REIT – Mortgage REIT Structures



Captive REITs – Basic State Tax Issues

DPD / DRD Double Deduction

- Federal income tax REIT law attempts to eliminate one level of taxation by allowing a REIT to deduct dividends paid.
- The necessary corollary of the REIT DPD is that a REIT shareholder is not allowed a DRD for any dividend received from a REIT. This principle is codified in multiple places within the IRC.
- Captive REIT structures often attempt to exploit state income tax systems that:
 - adopt federal REIT treatment at the REIT level – ie the state allows a DPD, BUT
 - have not explicitly conformed their dividends received deduction (DRD) to make REIT dividends non-deductible for REIT owners.
- Captive REITs attempt to achieve a double deduction.

Captive REITs – Basic State Tax Issues

Transforming Income from Real Property into Income from an Intangible – A Nexus Problem

- Rental REITs transform income attributable to real property (rent), and taxable in your state, into a dividend that is likely not taxed anywhere.
 - Rent accrues at the REIT (nexus not a problem) where any potential income tax is eliminated by the DPD.
 - The dividend received by the REIT owner (nexus is a problem) is not taxed because:
 - Non-IRC conforming DRD allows REIT dividend double deduction, or
 - REIT owner is located out of state in a tax haven or a combined return jurisdiction – Nexus Problem.

Captive REITs – Basic State Tax Issues

Mortgage REITs – “Belt and Suspenders” Protection

- Mortgage REITs, like other captive REITs, often take advantage of the DRD / DPD double dividend deduction.
- But unlike other captive REITs, mortgage REITs can avoid an in-state filing obligation because they own intangibles (mortgages or mortgage backed securities) not real property.
- Mortgage REITs function like, and essentially are, investment holding companies that can attempt to isolate themselves in a tax haven or a combined return jurisdiction.
- Likewise the REIT owner / taxable dividend recipient may be an intermediate subsidiary holding company lacking in-state nexus creating contacts.

Captive REITs – DOR Challenges

- REIT owner not entitled to the DRD double deduction. See Massachusetts *BancBoston* case.
- Captive REIT not entitled to REIT status and DPD. See the Massachusetts *Fleet Funding* case.
 - Sham / Business Purpose / Economic Substance arguments
 - Was the property transferred to the REIT? Was transfer recorded?
 - Who are the shareholders? Employees? Charities?
 - Does the REIT satisfy the IRC 100 shareholder rule?
- Deny the REIT DPD using an add-back statute.
 - Is the DPD an intangible expense?
- Deny the rent expense deduction to the operating company.
 - Is property recorded in operating company's name?
- Nexus with the REIT owner? See Louisiana *AutoZone*.

Captive REITs – Legislative Fix

- MTC beginning work on uniform state income tax REIT provisions.
- All state dividend received deductions should deny the deduction for dividends received from a REIT – *ie. conform to federal DRD*.
 - Consider denying DRD for dividends received indirectly from a REIT (dividends that are “cleansed” by passing through a REIT holding company).
- State REIT provisions should define “Captive REITs” and deny REIT treatment – the DPD – to Captive REITs.
 - “Captive REIT” should mean any REIT with a greater than 50% (vote or value - including attribution) shareholder.
- NAREIT, the national lobby for publicly traded REITs, can be recruited to support Captive REIT legislation.

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QUESTIONS?