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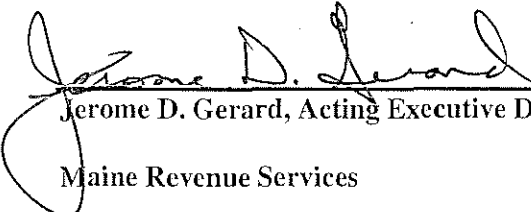


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**An Analysis of the Income Taxation of Real Estate Investment Trusts**

Submitted to the Joint Standing Committee on Taxation of the 123<sup>rd</sup> Legislature

On December 9, 2008 by

  
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Maine Revenue Services

## INTRODUCTION

The Joint Standing Committee on Taxation of the 123<sup>rd</sup> Legislature requested that the Bureau of Revenue Services (“Maine Revenue Services” or “MRS”) analyze the federal and state taxation of Real Estate Investment Trusts (“REITs”) and related entities and to report back to the Committee by January 16, 2009.

MRS requested written submissions and comments on the report topics from parties that delivered testimony regarding REITs at the public hearing on LD 2074, An Act to Reestablish Fairness in Corporate Taxation by Taxing Real Estate Investment Trusts. Copies of all final written submissions received by MRS can be found as attachments to this report. MRS also invited those parties to participate in a meeting held on July 29, 2008 regarding the federal and state taxation of REITs. Representatives from the following parties attended the meeting with MRS personnel: National Association of REITs, CNL Lifestyle Properties, Inc., Plum Creek Timber, Maine Public Employees Retirement System, Maine Chamber of Commerce, and the Maine Forest Products Council. Rep. Robert Duchesne and Julie Jones, Senior Legislative Analyst, OFPR, also attended.

The creation of the report stems from the Taxation Committee’s consideration of LD 2074, a bill sponsored by Rep. Duchesne in the 123<sup>rd</sup> Legislature. The Taxation Committee requested that MRS consider certain topics related to the federal and Maine taxation of REITs, Taxable REIT Subsidiaries (TRSs) and REIT owners, Maine taxation of Captive REITs, and investment in REITs by Maine individuals and by REITs in Maine communities.

This report discusses federal and state tax law as it applies to REITs, related entities and owners. The analysis of investments in REITs or by REITs in Maine is distinct from tax law and outside the expertise of MRS staff. Thus, this report provides a brief non-critical summary of the information provided by Maine Public Employees Retirement System (MPERS) on this topic and refers the Committee to submissions by the invitees.

## **FEDERAL TAXATION OF REITs**

### REIT Status

REITs, or real estate investment trusts, were first authorized by Congress in 1960 to increase the use of pooled investments by small investors in the real estate market.<sup>1</sup> A REIT is a corporation, trust or association that would normally be subject to taxation as a domestic corporation but for an election of tax treatment under the special REIT provisions in the Internal Revenue Code (“Code”) which effectively allow for the pass-through taxation of almost all income through the use of a special dividends paid deduction.<sup>2</sup> A REIT may revoke its election to be treated as a REIT for tax purposes at any time.<sup>3</sup> Beneficial ownership of a REIT must rest in at least 100 shareholders or members.<sup>4</sup> REITs are also subject to specific income and asset test requirements to maintain status as a REIT.

### Income Tests

At least 95% of a REIT’s gross income must derive from certain sources, such as from dividends, interest, rents from real property (defined to include customary service

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<sup>1</sup> Thornton Matheson, “Taxable REIT Subsidiaries: Analysis of the First Year’s Returns,” *Statistics of Income Bulletin*, Spring 2005, Volume 24, Number 4, pp. 114.

<sup>2</sup> 26 U.S.C. § 856(a)(3).

<sup>3</sup> 26 U.S.C. § 856(g).

<sup>4</sup> 26 U.S.C. § 856(a)(5).

charges and certain related personal property rent), gain from the sale or disposition of certain real property, abatements/refunds of taxes and amounts attributable to consideration for entering into certain real estate contracts.<sup>5</sup> At least 75% of that total gross income must come from real estate sources, including rents, gain from the disposition of real property, and other related kinds of income.<sup>6</sup> Rental income is defined to include the gain from sales of cut timber.<sup>7</sup> Sales of timber from a REIT to a TRS under IRC section 631 qualify for the 75% test.<sup>8</sup> The section on prohibited transactions below discusses in more detail the limitations on sales by REITs.

### Asset Tests

At the close of its fiscal year, a REIT must have at least 75% of its total assets in real estate assets, cash or government securities.<sup>9</sup> A REIT may hold no more than 25% of its assets in securities and no more than 25% of its total assets can be held in securities of one or more of its TRSs.<sup>10</sup> Additional restrictions related to value of assets and voting powers related to the securities are found in 26 U.S.C. § 856(c)(4)(B)(iii). An entity that fails the asset tests will lose its status as a REIT unless the failures are de minimis.<sup>11</sup>

### Taxation of REIT Income

A REIT calculates its tax in a manner similar to a corporation, except that, unlike corporations, REITs are allowed a dividends paid deduction for dividends paid out to its

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<sup>5</sup> 26 U.S.C. § 856(c)(2), 856(d)(1).

<sup>6</sup> 26 U.S.C. § 856(c)(3).

<sup>7</sup> I.R.S. Priv. Ltr. Rul. 199925015 (1999), 199927021 (1999), 199945055 (1999); Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246.

<sup>8</sup> Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246. See attachment 7 for additional information on changes to the laws affecting Timber REITs, Lodging REITs, and Healthcare REITs.

<sup>9</sup> 26 U.S.C. § 856(c)(4).

<sup>10</sup> Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246; Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289.

<sup>11</sup> 26 U.S.C. § 856(c)(4), (7).

shareholders.<sup>12</sup> Because REITs are required to distribute at least 90% of their taxable income, excluding net capital gain, to its shareholders annually, the dividends paid deduction will lower by a minimum of 90% the REIT's income subject to taxation.<sup>13</sup> A REIT that retains any remaining income will pay tax on that amount at the corporate rate.<sup>14</sup>

### Prohibited Transactions

Net income from "prohibited transactions" is subject to a 100% tax.<sup>15</sup> Net income is the excess of gain from the prohibited transaction over the deductions allowed to the REIT.<sup>16</sup> A prohibited transaction is the sale or other disposition of property held primarily for sale to customers in the ordinary course of a trade or business (also known as "dealer property") as defined in § 1221(a)(1) other than sales of foreclosure property and sales qualifying under the safe harbor provisions of §857(b)(6). Effective for sales made after July 30, 2008, the property is no longer required to be held for four years prior to the sale to qualify for the safe harbor, but must be held only for two years.<sup>17</sup> Safe harbors limit sales to either seven properties per year or to an amount where the aggregate tax bases or fair market value of sold properties does not exceed 10% of the total tax basis of the REIT's assets.<sup>18</sup> Additional special rules and safe harbors apply to timberland sold by a REIT.<sup>19</sup>

### Taxation of REIT Shareholders

Distributions from a REIT to its shareholders take three forms: dividends, capital gain distributions and return of capital. REIT shareholders report the applicable

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<sup>12</sup> 26 U.S.C. § 857(b)(2).

<sup>13</sup> 26 U.S.C. § 857(a)(1).

<sup>14</sup> 26 U.S.C. 857(b)(1).

<sup>15</sup> 26 U.S.C. § 857(b)(6)(A).

<sup>16</sup> 26 U.S.C. § 857(b)(6)(B)(i), (iii).

<sup>17</sup> Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289.

<sup>18</sup> 26 U.S.C. § 857(b)(6)(C); Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289.

<sup>19</sup> 26 U.S.C. § 857(b)(6)(D).

distributions on their federal individual income tax return, or, in the case of a corporate shareholder, on the corporate income tax return. REIT dividends are subject to the same dividend tax rates as ordinary dividends.<sup>20</sup> Shareholders receiving capital gains distributions are taxed at the 5% or 15% rates.<sup>21</sup> Return of capital is not taxed, but lowers the shareholder's basis in the REIT stock, resulting in a larger capital gain on the sale of that investment later.

#### Taxable REIT Subsidiaries

REITs are allowed two kinds of subsidiaries: qualified REIT subsidiaries (QRSs) and taxable REIT subsidiaries (TRSs). The stock of a QRS is held entirely by the parent REIT and the assets, liabilities, income and losses of a QRS are treated as those of the REIT.<sup>22</sup> A TRS is a corporation in which a REIT owns up to 100% of its stock and which elects, along with the REIT parent, for the TRS to be subject to taxation. A TRS can also include a subsidiary owned more than 35% by a TRS. The law prohibits lodging facilities and health care facilities from qualifying as TRSs,<sup>23</sup> but a parent REIT can own a lodging or health care facility that is rented to a TRS and managed by an eligible independent contractor.<sup>24</sup> It appears that that IRC §§ 857(b)(7)(C) and 482 read together require that transfers of land from a REIT to a TRS for development are made as a sale for fair market value. This is the position of NAREIT and other REIT representatives that have provided information to MRS on this issue.<sup>25</sup> A TRS, as a corporation, is subject to corporate income tax at the federal and state levels.

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<sup>20</sup> 26 U.S.C. §316.

<sup>21</sup> I.R.S. Notice 2004-39, 2004-1 C.B. 982.

<sup>22</sup> 26 U.S.C. § 856(i).

<sup>23</sup> 26 U.S.C. § 856(l).

<sup>24</sup> Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289.

<sup>25</sup> See attachments 8 and 9.

## STATE TAXATION OF REITs

Maine corporate income tax is imposed on each taxable corporation at rates up to 8.93% on the corporation's net income.<sup>26</sup> Net income is defined as "the taxable income of the taxpayer for that taxable year under the laws of the United States as modified by section 5200-A."<sup>27</sup> The federal taxable income of a REIT equals the REIT's income after deductions for net operating losses, the dividends paid deduction, and certain federal taxes paid by the REIT for failure to meet REIT requirements. The Maine gross tax is figured on this adjusted federal taxable income after modification by the additions and subtractions required pursuant to section 5200-A. For corporations in business in Maine and other states, the gross tax is subject to apportionment to determine the Maine corporate income tax and then offset by any applicable credits.<sup>28</sup> Generally other states use this approach for imposing state level income tax on REITs. New Hampshire, however, applies an entity level tax to REIT income without subtracting the dividends paid; several other states apply a minimum tax.<sup>29</sup>

## CAPTIVE REITs

A captive REIT is a REIT that is majority owned by a parent corporation, sometimes through a REIT holding company, with a minority of ownership residing in that corporation's officers or directors so that the 100 shareholder requirement is met. In a typical transaction, a related subsidiary corporation, possibly a retailer, rents its real property from the captive REIT, which must distribute at least 90% of this rent to its shareholders, including the parent corporation or REIT holding company set up in a

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<sup>26</sup> 36 M.R.S.A. § 5200(1).

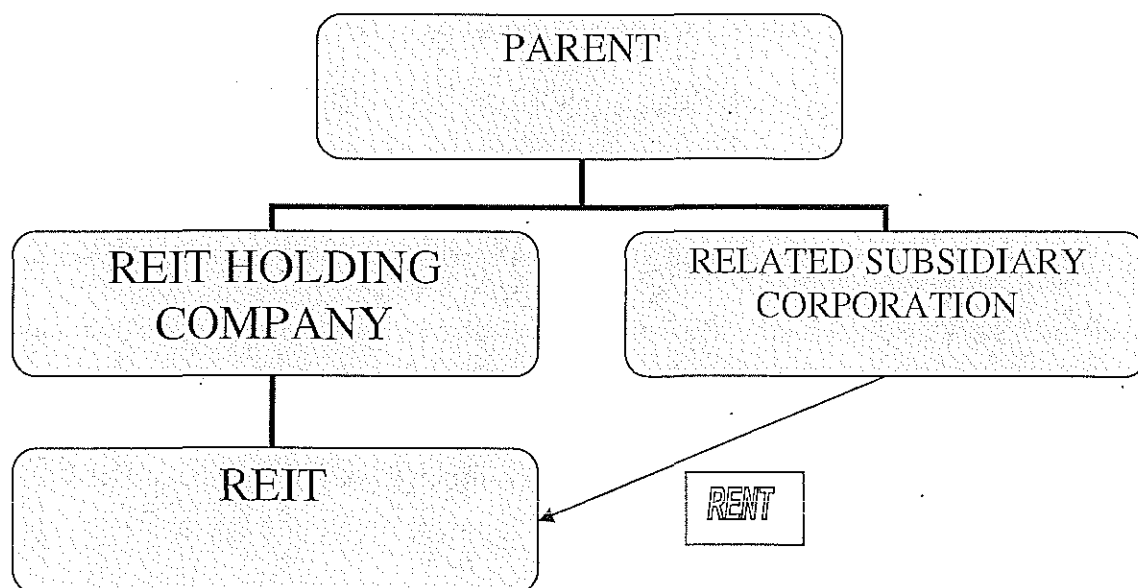
<sup>27</sup> 36 M.R.S.A. § 5200(5).

<sup>28</sup> 36 M.R.S.A. § 5211, Ch. 822.

<sup>29</sup> See, e.g., N.H. Rev. Stat. Ann. Ch. 77-A, 77-E; Haw. Rev. Stat. § 235-71(d); Conn. Gen. Stat § 12-219; and Cal. Rev. & Tax Code 23151, 23153.



jurisdiction with no income tax. The related subsidiary corporation deducts the rental payments as business expenses. The REIT receives the rental payments, which are reflected in the REIT's gross income. The REIT then distributes 90% of its taxable income to shareholders as dividends. The shareholders, including the parent corporation or holding company, will report the dividends on the state tax returns of their state of residence (if that state has an income tax), unless the parent or holding company is also required to file as part of a combined group in the states in which the parent corporation does business.<sup>30</sup> See diagram below.



Maine law requires that corporations that are part of an affiliated group and engaged in a unitary business file a combined report, alleviating most of the concerns suggested by the captive REIT structure.<sup>31</sup> As part of the submission from the invitees, certain possible scenarios in which Captive REITs could be utilized in Maine to avoid

<sup>30</sup> Jesse Drucker, *Friendly Landlord: Wal-Mart Cuts Taxes by Paying Rent to Itself*, Wall St. J., Feb 1, 2007.

<sup>31</sup> 36 M.R.S.A. §§ 5102(1-B), 5244.

taxation were put forth.<sup>32</sup> Such scenarios include the use of a foreign subsidiary corporation, a financial institution, or a non-captive insurance company as the majority shareholder of the captive REIT, because such entities are not part of a combined report under Maine law.

Other states without combined reporting have recently enacted legislation, with support from the National Association of REITs, to address the use of captive REITs.<sup>33</sup> These laws, however, do not address issues raised by the use of foreign subsidiary corporations or corporations that are taxed under special taxing regimes (like Maine's franchise tax or insurance taxes).

### **REIT INVESTMENT**

According to figures provided by Andrew Sawyer, the Chief Investment Officer of the Maine Public Employees Retirement System (MPERS), as of March 31, 2008, MPERS has \$520 million investment in real estate, including \$83 million in a REIT index fund. The total asset value of MPERS on that same date was approximately \$10 billion. For figures from invitees on REIT investment in Maine, please see attachments 3 and 4. As noted earlier, investment analysis is not a function of MRS and therefore MRS has not verified the information presented, but is merely reporting responses by invitees to the request for information posed by the Taxation Committee.

### **CONCLUSION**

MRS considered the above issues as requested by the Joint Standing Committee on Taxation of the 123<sup>rd</sup> Legislature with the assistance of the above-mentioned invitees and hereby submits this report and attachments for the Committee's review.

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<sup>32</sup> See attachment 5.

<sup>33</sup> See attachments 4 and 5.

### Appendix of Attachments

1. Letter dated March 17, 2008 from the Joint Standing Committee on Taxation of the 123<sup>rd</sup> Legislature
2. Letter dated June 29, 2008 from Rep. Robert S. Duchesne
3. Letter dated July 23, 2008 from Joseph T. Johnson, Senior Vice Present and Chief Accounting Officer, CNL Lifestyle Properties, Inc.
4. Letter with attachments dated July 25, 2008 from Dara F. Bernstein, Senior Tax Counsel, National Association of Real Estate Investment Trusts
5. Memo with attachments dated July 28, 2008 from Pierce Atwood, LLP on behalf of the Maine Forest Products Council
6. Letter with attachment dated August 21, 2008 from William P. DeKlerk, Director Tax Planning and Compliance, Plum Creek Timber Company
7. Letter with attachment dated August 29, 2008 from Dara F. Bernstein, Senior Tax Counsel, National Association of Real Estate Investment Trusts
8. Letter dated November 6, 2008 from William P. DeKlerk, Director Tax Planning and Compliance, Plum Creek Timber Company
9. Letter dated November 12, 2008 from Dara F. Bernstein, Senior Tax Counsel, National Association of Real Estate Investment Trusts