NAREIT State & Local Tax Policy Bulletin

National Association of Real Estate Investment Trusts®
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State & Local Tax Policy Bulletin

This is the first issue of NAREIT's *State & Local Tax Policy Bulletin* (*SALT Bulletin*) in 2009 and provides a summary of recent state and local tax developments affecting REITs.

Highlights

Captive REIT Developments
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Other REIT Developments
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- Philadelphia: Potential Partnership "DPD" Repeal - P.10

Please join NAREIT and NAREIT State & Local Tax (SALT) Subcommittee Co-Chairs Michele Randall (Deloitte Tax) and Tim Hall (First Industrial Realty Trust) at the State & Local Tax Subcommittee meeting on Wednesday, March 25, 2009, from 4:30-6:00 p.m. at REITWise™: NAREIT's Law, Accounting & Finance Conference. REITWise will be held March 25-27 at the La Quinta Resort & Club in La Quinta, CA and combines legal, accounting and finance issues concerning REITs and real estate investment to create one of the most informative and useful conferences of the year. This year's SALT Subcommittee meeting will focus on the state and local tax implications relating to maintaining liquidity (such as stock dividends and debt forgiveness). It also will provide an update of a number of state and local tax developments as well, including Massachusetts' conformity to the federal check-the-box rules, transfer taxes in Michigan and Maryland, and the proposed repeal of the partnership "dividends paid deduction" in Philadelphia.

CAPTIVE REIT DEVELOPMENTS

By way of background, the Multistate Tax Commission (MTC), an organization of state governments that recommends uniform statutes released a model captive REIT statute in June 2008. NAREIT appreciated the opportunity to participate in the MTC's drafting process over a number of years. The MTC's model statute generally would disallow a dividends paid deduction (DPD) for a non-listed REIT the interests of which were more than 50% owned by a taxable, non-REIT C corporation. For these purposes, Australian REITs (also called listed Australian property trusts) and similar, foreign REIT-like entities were not considered C corporations. A number of states adopted captive REIT legislation last year based on the MTC model statute. *See* the August 2008 *SALT Bulletin* for further details. Recent state legislation relating to captive REITs is set forth below.

ARKANSAS: CAPTIVE REIT LEGISLATION BASED ON MTC MODEL STATUTE

Arkansas recently enacted a captive REIT statute based on the MTC model statute, Act 372, which became effective March 11, 2009 for tax years beginning on and after January 1, 2009.

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COLORADO: CAPTIVE REIT REPORTING REQUIREMENTS IN PROCESS BASED ON MTC MODEL STATUTE

BACKGROUND

Gov. Bill Ritter (D-CO)

On June 3, 2008, Governor Bill Ritter (D) vetoed H.B. 1408. H.B. 1408 would have affected the taxation of captive REITs. Like most states that have adopted captive REIT legislation, this bill used a definition of captive REIT very similar to the MTC's definition.

REPORTING OF CAPTIVE REIT TRANSACTIONS REQUIRED

Rep. Claire Levy (D) introduced a similar bill, H.B. 09-1093, in the current legislative session. Both the Colorado House and Senate have passed H.B. 09-1093, and it is awaiting signature by the Governor. While H.B. 09-1093 uses a definition of captive REIT that is based on the MTC's definition of such term, H.B. 09-1093 would not disallow a DPD; instead, it requires reporting for transactions between a captive REIT and its more-than-50% shareholder.

GEORGIA HOUSE PASSES MTC-BASED CAPTIVE REIT ADDBACK STATUTE

On March 10, 2009, the Georgia House passed H.B. 379, a bill that would require a taxpayer to add back to taxable income expenses and costs paid to a captive REIT (the Addback). H.B. 379 generally uses the MTC's definition of captive REIT. H.B. 379 contains a number of provisions that would reduce the amount of the Addback, such as if the captive REIT is subject to tax, and in fact pays tax in Georgia or another state, on such amounts (after the DPD). H.B. 379 is now being considered by the Georgia Senate.

ILLINOIS: MTC-BASED CAPTIVE REIT BILL RE-INTRODUCED

BACKGROUND

In 2007, Illinois first enacted a captive REIT statute, S.B. 1544, which was very similar to the typical state captive REIT. However, in early 2008, Illinois subsequently enacted a "trailer bill" (including non-REIT provisions), S.B. 783, that made some adverse changes to the captive REIT provisions.

Specifically, S.B. 783 treats a REIT as a captive if more than 50% owned by a "person," including a partnership. A REIT more than 50% owned by another REIT, LAPT or tax-exempt organization would not be viewed as a captive, but a REIT more than 50% owned by a partnership itself equally owned by these "qualifying" entities would be viewed as a captive.

REVERSION TO CORPORATE TRIGGER FOR CAPTIVE REIT STATUS SOUGHT

NAREIT has been working through a local advocacy group to educate the Illinois Department of Revenue as to the fact that this change would affect legitimately formed REITs, and, in fact, last year, Senator Don Harmon (D) introduced S.B. 2643, a bill that would have clarified the DPD disallowance for captive REITs that was enacted in 2007. This bill passed the Illinois Senate and the House but only after the House included an amendment limiting the Illinois Department of Revenue's rulemaking authority. Because the Illinois Senate voted not to concur in the House's amendment, S.B. 2643 was not enacted last year. Importantly, S.B. 2643 would have defined a captive REIT as a REIT more than 50% owned by a taxable non-REIT (or listed Australian property

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trust) **corporation,** rather than more than 50% owned by a **partnership**.

BILL USING CORPORATE TRIGGER FOR CAPTIVE REIT STATUS INTRODUCED

On Feb. 20, 2009, Senator Harmon introduced S.B. 1975, a bill substantially similar to S.B. 2643. On Mar. 12, 2009, S.B. 1975 passed out of the Senate Revenue Committee. The bill is now on the Order of Second Reading. The deadline for the bill to pass out of the Senate is April 3. (In order for a bill to be enacted in Illinois, it must have three readings before each legislative body: the first to introduce the bill, the second to allow for floor amendments, and the third to vote on the bill.) We are cautiously optimistic the bill will be passed to the House by the deadline.

INDIANA: CAPTIVE REIT CHANGES PENDING TO CONFORM TO MTC MODEL STATUTE

BACKGROUND

In 2007, Indiana enacted legislation limiting the DPD of captive REITs, which generally were defined as non-listed REITs the interests of which were more than 50% held by a taxable, non-REIT corporation. However, this legislation did not exempt from captive REIT status a non-listed REIT held by a listed Australian property trust (or any other foreign, REIT-like entity) as in the MTC model statute.

MTC-BASED CAPTIVE REIT CHANGES INTRODUCED

Two bills relating to captive REITs have been introduced in the Indiana legislature: S.B. 541 and H.B. 1684. Both S.B. 541 and H.B. 1684 would bring Indiana more in line with the MTC model statute by not treating non-listed REITs owned by foreign, REIT-like entities as captive REITs. S. 541 is the Indiana Department of Revenue's

technical corrections bill. As such, it generally is expected to be enacted. It passed the Indiana Senate on Feb. 10, 2009, and has been assigned to the Indiana House Ways and Means Committee, which has taken no action to date. While S.B. 541 would be retroactive to Jan. 1, 2008, H.B. 1684 would apply to taxable years beginning after Dec. 31, 2008. H.B. 1684 deals only with the definition of captive REIT while S.B. 541 is more comprehensive. There has been no action on H.B. 1684 since its introduction on Jan. 16, 2009, and its referral to the Indiana House Committee on Rules and Legislative Procedures.

KENTUCKY: CAPTIVE REIT CHANGES PENDING

BACKGROUND

Kentucky enacted legislation limiting the DPD of captive REITs in 2007 *See SALT Bulletin* 2007-2 for more details. Unlike the MTC model captive REIT statute, the ownership threshold for captive REIT status was 25%. Additionally, there was no special rule for non-listed REITs more than 25% owned by listed Australian property trusts or similar foreign, REIT-like entities.

CHANGES TO CAPTIVE REIT LEGISLATION PROPOSED

On Feb. 23, 2009, Representative John A. Arnold (D) and Representative Tim Firkins (D) introduced H.B. 513, which would modify

Kentucky's treatment of captive REITs. First, it would modify the definition of captive REIT as follows. A non-listed REIT would be treated as a captive REIT if interests in such entity are more than 25% held by a corporate non-tenant. On the other hand, a non-listed REIT would be treated as a captive REIT if interests in such entity are more than 10% held by a corporate tenant (other than a REIT, listed Australian property trust or similar foreign entity). Second, instead of limiting the DPD of a captive REIT, H.B. 513 would require an add back to taxable income of payments made to the captive REIT by two types of taxpayer. The first case would be with respect to payments made to the captive REIT by a non-tenant owner that owns more than 25% of the interests in the captive REIT. The second case would be with respect to payments by a tenant of the captive REIT if the tenant is a corporate entity that owns more than 10% of the interests in the captive REIT. On Feb. 24, 2009, H.B. 513 was assigned to the Kentucky House Appropriations & Revenue Committee. No further action has been taken to date on H.B. 513.

OREGON: PROPOSAL TO INCLUDE REITS IN CONSOLIDATED GROUP FILING

Thanks to Tim Hall of First Industrial Realty Trust for the following submission.

By way of background, Oregon's general filing methodology is unique in that it is neither a nexus consolidated return or a unitary return filing state. Instead, Oregon's tax filing methodology requires inclusion of all members of a federal consolidated return (as defined under Internal Revenue Code Section 1504), but only those members of the federal consolidated return that are part of the same unitary group.

On Jan. 15, 2009, S.B. 180 was filed in the Oregon Senate. S.B. 180 is being advocated by the Oregon Department of Revenue. Unlike the captive REIT statutes in other states, S.B. 180 would bring captive REITs into the general filing methodology in Oregon by redefining a federal affiliated group (that is, a corporate group linked by at least 80% stock ownership) to include REITs. Although this legislation would appear to address captive REITs, it may have broader implications. For example, a traditional REIT (not in umbrella partnership REIT or "UPREIT" structure) could be required to file a consolidated tax return in Oregon if it owned more at least 80% of a taxable REIT subsidiary (TRS), which may or may not result in a greater Oregon tax liability. On the other hand, an UPREIT with a TRS below the REIT's operating partnership (OP) still would file a separate return in Oregon for the TRS. This result is different than most unitary states in which the REIT would file a combined return with the TRS even though the OP is in between the REIT and the TRS.

The Senate Revenue and Finance Committee held a hearing on S.B. 180 on Feb. 3, 2009, and there has been no further action to date on this bill.

VIRGINIA LEGISLATURE PASSES CAPTIVE REIT DPD DISALLOWANCE

The Virginia legislature has passed identical bills based on the MTC model captive REIT statute, H.B. 2504 and S.B. 1147. These bills would deny a DPD to a captive REIT. They are awaiting signature by Governor Tim Kaine (D).

WISCONSIN: GUIDANCE ON CAPTIVE REIT ADD BACK STATUTE RELEASED

BACKGROUND

As reported in the August 2008 *SALT Bulletin*, last year Wisconsin enacted an "add back" statute (2007 Wisconsin Act 226), which included provisions relating to "qualified REITs," as so defined (essentially non-captive REITs). Provisions of this legislation (the Act) require interest and rent expenses paid, accrued, or incurred to a related party (Related Entity) to be added back to income (the Addback Rule). However, the Act allows a deduction for those expenses if certain requirements, including disclosure of the payment's existence to the Wisconsin Department of Revenue (DOR), are met. Another requirement is that the related entity is subject to tax at least equal to 80% of the taxpayer's "aggregate effective tax rate" (the Subject to Tax Rule).

REGULATORY GUIDANCE SOUGHT

An open question under last year's legislation has been the deductibility of payments made to flow-through entities owned by qualified REITs. NAREIT sought regulatory guidance confirming that payments to such flow-through entities should be treated as payments to the ultimate owners of the pass-through entities. NAREIT also sought regulatory guidance that the Subject to Tax Rule applies before deductions. Thus, net operating losses or other deductions should not affect whether a taxpayer is considered "subject to tax."

REGULATORY GUIDANCE RELEASED

Ultimately, the Wisconsin DOR issued guidance relating to the addback statute in Wisconsin Tax Bulletin 158 – October 2008. Question and Answer A3 of this guidance addresses the situation in which a qualified REIT is a partner of a partnership which owns a subsidiary treated as a

taxable REIT subsidiary (TRS), and the TRS pays interest and rental expenses to the partnership subject to the addback. The DOR concludes that "[i]nterest and rental expenses paid, accrued, or incurred from the TRS to the partnership will generally be not subject to the addback to the extent the partnership income flows through to a qualified REIT." However, in cases where a flow-through entity "does not have a legitimate purpose other than tax avoidance, lacks economic substance, or results in distortion of income or evasion of taxes," the DOR has authority to make adjustments in order to prevent evasion of taxes or to more clearly reflect the taxpayer's income.

This guidance also addresses the Subject to Tax rule in Question and Answer C7 and C8. In Question and Answer C7, the DOR concludes that income still is "subject to tax" even if the taxpayer has loss carryforwards that reduce the taxable income. However, in Question and Answer C8, the taxpayer's income considered "subject to tax" "is the amount taxable to the entity after application of the dividends paid deduction."

For more questions and answers regarding the Wisconsin addback statute, see the Wisconsin DOR Tax Bulletin 159 – January 2009.

OTHER DEVELOPMENTS

CALIFORNIA

NAREIT thanks Steve Ryan of Grant Thornton LLP for his contributions to the following.

FTB NOTICE 2009-01 – DEFERRED INTERCOMPANY STOCK ACCOUNT BALANCE DISCLOSURE

The California Franchise Tax Board (FTB) recently issued Notice 2009-01 to remind corporate taxpayers of the state's accounting and disclosure requirements pertaining to deferred intercompany stock account (DISA) transactions and to advise taxpayers that Form 3726 has been issued to facilitate the disclosure requirement. The DISA is the accounting mechanism that a distributee corporation will use to report and track non-dividend distributions in excess of its adjusted stock basis of the distributing corporation, where the distrubutee and distributing corporations are members of the same combined (unitary) group, until this intercompany item is required to be taken into income. The balance of each DISA must be disclosed annually on the taxpayer's return. Notice 2009-01 is relevant for TRSs filing on a combined (unitary) group basis for California franchise tax purposes, including such groups that include a REIT parent in the combined filing.

In order to comply with the annual California DISA disclosure requirement, the FTB has issued Form 3726, DISA and Capital Gain Information. *An appropriately completed Form 3726 must be included with a taxpayer's original 2008 return and every year thereafter, if a member of the combined group has a DISA balance.*

The FTB is providing taxpayers an opportunity to disclose their 2001-2007 DISA balances on an entity-by-entity basis by submitting Form 3726 to the FTB by May 31, 2009 in order to provide some amnesty for prior non-compliance with the DISA regime.

For further information on this issue, please see this Grant Thornton LLP *SALT Alert.*

CERTIORARI FILED IN *VENTAS FINANCE I* RE UNCONSTITUTIONAL FEE

The apparently never-ending saga of the unconstitutional California limited liability company (LLC) fee (tax) continues.

The May 2008 *SALT Bulletin* discussed several California court cases in which California's LLC fee was held to be an unconstitutional "tax" because it was not based on apportioned income. *Northwest Energetic Services, LLC v. Franchise Tax Board*, San Francisco Super. Ct. No. CGC-05-437721 (Mar. 3, 2006) *aff'd*, 159 Cal. App. 4th 841 (Cal. App. 2008, (LLC fee was unconstitutional; taxpayer had no gross receipts in California), *Ventas Finance I, LLC v. Franchise Tax Board*, San Francisco Superior Court No. CGC-05-44001, (Nov. 17, 2006) (LLC fee was unconstitutional; taxpayer had gross receipts both within and outside of California), *aff'd in part and rev'd in part*, 165 Cal. App. 4th 1207 (Cal. Ct. App., 2008), and *Bakersfield Mall, LLC v. Franchise Tax Board*, San Francisco Superior Court Docket No. CGC07462728, Court of Appeal, 1st Appellate District No. A119709 (filed April 27, 2007) (taxpayer had only California-source gross receipts).

The Franchise Tax Board decided not to appeal the *Northwest* case; it is final. As a result of the *Northwest* case, the Franchise Tax Board (FTB) had issued a notice in order to facilitate refunds for taxpayers with no California source income.

While the other LLC fee cases were pending, the state of California, recognizing the huge potential revenue drain from refunding millions of dollars in LLC fees, amended its LLC fee statute to provide that any refunds with respect to the prior LLC fee should be based on apportioned income (in an attempt retroactively to make the LLC fee constitutional). We understand that the FTB has delayed issuing refunds until the resolution of all pending cases.

Although the California appellate court in the *Ventas* court held that the LLC fee was unconstitutional since it was not based on apportioned income, it nevertheless decided that the taxpayer was not entitled to a full refund of the LLC fee, but only the amount in excess of the LLC fee it would have paid had the LLC fee been based on apportioned income. Ventas Finance I, LLC recently filed a Petition For Writ of Certiorari for the U.S. Supreme Court to review this decision. Ventas' arguments address the parameters of the doctrine requiring the separation of judicial and legislative authority, the ability of a court to reform a statute - notwithstanding the prior legislative intent to specifically reject the considered provision (because the California legislature considered and rejected an apportionment methodology when enacting the LLC fee), and the Due Process Clause (because the *Ventas* court is retroactively changing the taxpayer's obligations).

MAINE: NO REIT TAX LEGISLATION INTRODUCED THIS SESSION; NAREIT MONITORING DEVELOPMENTS

As we noted in the last *SALT Bulletin*, last year, Rep. Robert Duschesne (D) proposed legislation (L.D. 2074) that would have imposed Maine's corporate income tax on a REIT's capital gains. Ultimately, the legislature did not approve the legislation, but it did ask for Maine Revenue Services to complete a study that addressed a number of questions relating to REITs, TRSs, and the benefit to local communities and shareholders of investments by and in REITs. On Jul. 29, 2008, Maine Revenue Services held a meeting of the REIT Study Group, which Dara Bernstein of NAREIT attended. NAREIT also filed two written submissions, which can be viewed by clicking here and here.

On Dec. 10, 2008, Maine Revenue Services released its final report. The final report made no policy recommendations regarding REITs, but merely summarized the rules regarding the taxation of REITs and their shareholders in Maine. Although NAREIT had been advised to expect legislation similar to L.D. 2074 in the current legislative session, to date, none has been proposed. Nevertheless, NAREIT continues to monitor legislative developments in Maine that may affect NAREIT member REITs.

MARYLAND: PROPOSAL TO ELIMINATE SMALL BUSINESS EXCEPTION TO CONTROLLING INTERESTS TRANSFER TAX

S.B. 727, and its companion bill, H.B. 983, would extend Maryland's recordation and transfer taxes to transfers of controlling interests in real property entities with less than $1,000,000 in Maryland real estate. These bills also would require, when filing organizational documents with respect to an LLC with the State Department of Assessments and Taxation, that the organizational documents contain: 1) the name and address of each organizer and each member with the authority to execute

instruments on behalf of the LLC; and, 2) the name and address of any person who is not a member who is authorized to execute or file documents on behalf of the LLC. S.B. 727 is scheduled for a hearing in the Senate Budget & Taxation Committee on March 25, 2009, while H.B. 983's hearing with the Assembly's Ways & Means Committee was cancelled, and the bill was withdrawn by the sponsors.

MICHIGAN

REALTY TRANSFER TAXES RETROACTIVELY IMPOSED

NAREIT thanks Drew VandenBrul of KPMG for the following submission.

On Jan. 9, 2009, Michigan Governor Jennifer Granholm (D) signed into law Act 473 which retroactively imposes realty transfer tax on transfers of controlling interests in real property holding companies (the Act). The Act applies to contracts for the transfer or acquisition of controlling interests in entities meeting both an ownership test and an asset test.

In order for an entity to be considered a real property holding company, it must hold real property comprising 90% or more of the fair market value of its assets as determined under GAAP. If the asset test is not satisfied, the entity is not a real property holding company and the transfer tax will not apply to a transfer of a controlling interest in the entity.

Only contracts for the transfer or acquisition of a "controlling interest" in a real property holding company will be subject to the transfer tax. A "controlling interest" is a greater than 80% ownership interest in: 1) the value of all classes of stock of a corporation; 2) the total capital and profits of a partnership, association, limited liability company or other unincorporated business; or, 3) the beneficial interest in a trust. In is not clear from the Act whether a series of transfers over a period of time may be aggregated for purposes of applying the controlling interest test.

The amendments adopted by Act 473 are retroactive to **Jan. 1, 2007**. However, the Act does not specify how the State may enforce this retroactive provision. Act 473 requires the tax to be paid to the local county treasurer not later than 15 days after the transfer of a controlling interest in a real property holding company. It is unclear in on what form this transfer is to be recorded.

Act 473 does add some new exemptions to the state transfer tax. These include: 1) a transfer to dissolve the entity where the transfer of the property to owners or a creditor is necessary; 2) a transfer from a LLC or partnership to its members or owners, if the interests are held by the same owners in the same proportion as prior to the transfer; 3) a transfer of a controlling interest if the transfer would be exempt if transferred by deed between the same parties; and, 4) a transfer in connection with a reorganization where the beneficial ownership is unchanged.

The tax rate remains unchanged at $3.75 for each $500 or fraction thereof of the total value of the property being transferred. For transfers of controlling interests where less than 100% of the ownership is being transferred, the value is apportioned based on the percentage ownership transferred.

Act 473 does not address the county real estate transfer tax, which continues to apply to transfers of real property in which a deed is recorded at a rate of $.55 for each $500 or fraction thereof of the total value transferred.

DEFINITION OF "RECEIPTS" ALTERED IN MICHIGAN BUSINESS TAX

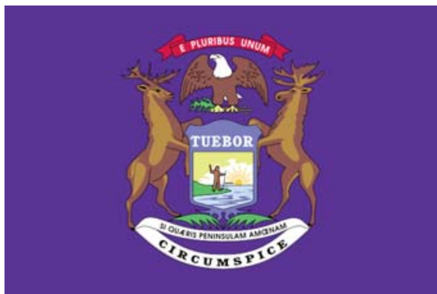
NAREIT thanks Michele Randall of Deloitte Tax LLP for alerting us to the following Michigan legislative development.

By way of background, in 2007, Michigan amended its business tax law that incorporates a gross receipts-based tax as well as an income tax. *See* the July 2007 *SALT Bulletin* for further details. The new business tax is called the Michigan Business Tax (MBT).

Taxpayers have raised a number of concerns regarding the MBT. Among other things, taxpayers (such as REITs) that invest through partnerships and similar flow-through entities were concerned the calculation of gross receipts under the MBT would consider both the receipts of the flow-through entity and the flow-through entity's owners.

However, on Jan. 9, 2009, Michigan Governor Granholm signed S.B. 1038. S.B. 1038 changes the definition of "gross receipts" for purposes of gross receipts portion of the MBT. Among other things, this amendment reduces from gross receipts "[a]mounts attributable to an ownership interest in a pass-through entity, regulated investment company, [or] real estate investment trust."

Also on Jan. 9, 2008, Governor Granholm signed S.B. 1052, which, among other things, modifies Michigan's definition of "taxable income" to decouple from the federal bonus depreciation rules of Internal Revenue Code § 168(k).



MONTANA

In 2007, Senator Jim Eliot (D) of Montana introduced S.B. 120 which would have denied a REIT's DPD. NAREIT and a number of REITs with Montana property successfully advocated against enactment of this legislation. *See SALT Bulletin* 2007-2 for further details. Senator Eliot later attempted unsuccessfully to pass another bill, which would have imposed a capital gains tax on REITs with Montana properties.

Recently, Representative Michele Reinhart (D) filed a request with the Montana legislative drafting agency to prepare legislative language for a bill similar to S.B. 120. At the present time, it is not clear whether Rep. Reinhart will introduce this legislation. NAREIT is monitoring legislative developments in Montana and will oppose this bill if it is introduced.

OHIO: REIT CORPORATE FRANCHISE TAX REPORTING REQUIREMENTS WAIVED

Among other things, Ohio Revised Code § 5733.09(C) generally requires REITs that are taxable in Ohio to report names, addresses and tax identification numbers of all shareholders by the last day of March of the tax or return year. As it typically does every year, the Ohio Department of Taxation issued a "Journal Entry" on Oct. 15, 2008, waiving this requirement for most REITs for franchise year 2009. The reporting requirement is not waived for those REITs in which at least a 20% interest is owned by a group of related entities other than a publicly traded REIT.

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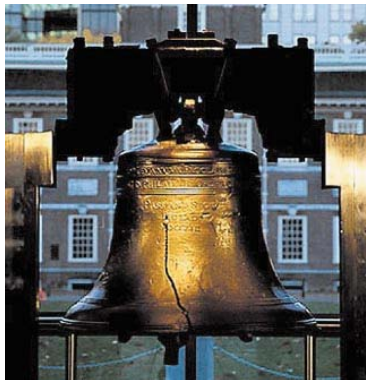
PHILADELPHIA: POTENTIAL REPEAL OF PARTNERSHIP "DPD"

NAREIT thanks Steve Ryan of Grant Thornton LLP for the following submission.

The Philadelphia Department of Revenue (DOR) conducted a Public Hearing on Feb. 13, 2009 regarding a proposed amendment (Proposed Amendment) to Sec. 224 of the Philadelphia Income Tax Regulations for Business Privilege Tax (BPT) purposes. The Proposed Amendment deletes certain language included in Section 224 (added in 1997) that essentially provides a deduction from the BPT net income tax base for partnership distributions (Partnership DPD) for qualifying partnerships. Specifically, this deduction applies to those partnerships with a REIT partner that would otherwise qualify as a REIT if the partnership were treated as a corporation that could elect REIT status (without regard to the REIT ownership tests). As a result of this deduction, qualifying partnerships are often able to eliminate the net income component of the BPT.



The Proposed Amendment would subject the partnerships to the net income component of the BPT in entirety, without regard to the percentage of ownership held by REITs. (Note that the BPT also includes a 'gross receipts' component that is not affected by the REIT provision, and that 60% of the BPT liability associated with the net income component is creditable against a separate tax, the net profits tax.)

For a number of years, certain members of the DOR have suggested eliminating the above-mentioned favorable treatment of REIT-owned partnerships. Because current law allows a deduction for all distributions – not just those distributions attributable to share of any REIT partner - current law can be seen as more favorable than if the REIT partners and their non-REIT partners invested directly.

As of the date of this writing, the Department is still contemplating the adoption of the Proposed Amendment and the related effective date of the Proposed Amendment.

TENNESSEE: PROPOSED LIMITATION ON FAMILY-OWNED PARTNERSHIPS; NO CHANGE TO RULES APPLICABLE TO REIT-OWNED PARTNERSHIPS

By way of background, Tennessee expanded its income (excise) tax and net worth (franchise) to partnerships over ten years ago. Since 2000, the income of REIT-owned partnerships has not faced income tax to the extent of the REIT's interest in the partnership. The 2001 change came about in part due to a NAREIT-sponsored coalition of REIT members that educated policymakers that taxing REIT-owned pass-through entities would conflict with the federal policy of shareholder-only level taxation. Further, at least for purposes of the income tax, REITs could have invested directly in the Tennessee real property with the same state tax consequences. *See* the Sept. 29, 2000 *SALT Bulletin* for further details. However, as most real estate businesses, REITs invest through partnerships for a number of purposes unrelated to taxes.

Similarly, the Tennessee franchise tax base for REIT-owned partnerships was calculated based only on the non-REIT partner or partners' interest in the partnership. However, in 2007, this treatment for REIT-owned flow-through entities

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under the franchise tax was repealed. At the same time, the income tax calculation for REIT-owned partnerships was modified so that only partnerships owned by publicly traded REITs would be exempt from the excise tax if they directly or indirectly distribute 100% of their net earnings or net losses to a publicly traded REIT.

There had been speculation last year that the Tennessee Department of the Revenue was considered changing the treatment of REIT-owned partnerships for purposes of the Tennessee excise tax, possibly to eliminate the above-described treatment for publicly traded REIT-owned partnerships. For that reason, NAREIT continues to monitor legislative developments in Tennessee.

To date, there have been no proposals concerning the taxation of REIT-owned partnerships. However, H.B. 2264 was introduced recently. This bill would eliminate the beneficial tax treatment of certain family owned "non-corporate entities" that invest in property other than residential real property and farmland. Governor Phil Bredesen (D) is expected to reveal his budget on March 23, 2009. NAREIT continues to monitor legislative developments in Tennessee.

VIRGINIA: PASS THROUGH ENTITY WITHHOLDING APPLIES TO REIT OWNERS

NAREIT thanks Drew VandenBrul of KPMG LLP for the following submission.

For taxable years beginning on or after Jan. 1, 2008, Virginia Code §58.1-486.2 requires pass-through entities (PTEs) to pay a 5% withholding tax on the portion of their Virginia taxable income allocable to nonresident owners. This withholding tax is required to be paid with the filing of Form 502 on or before April 15, 2009 for calendar year PTEs. Exceptions are generally limited to PTE owners exempt from federal taxation and where compliance will cause an undue hardship for the PTE. Nonresidents are defined by Virginia Department of Taxation (DOT) Public Document (P.D.)07-150 as individuals who are not residents of Virginia or other entities that do not have their commercial domicile in Virginia. An exception is provided in P.D. 07-150 for tiered partnerships where the upper-tier partnership agrees to file its on Form 502.

Therefore, a PTE owned by a REIT may be subject to this withholding requirement on the distributive share of income attributable to the REIT, notwithstanding Virginia's allowance of a DPD for the REIT. Some practitioners have approached the DOT for regulatory relief with respect to REIT owners of PTEs (that typically have no ultimate Virginia tax liability) and are hopeful that the DOT may provide such relief.

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

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