Captive REITs
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Frank Hales
Utah State Tax Commission

REIT definition

- In order to qualify as a REIT a corporation, trust or association must:
- • Be managed by one or more trustees or directors
- • Have transferable shares
- • Be taxed as a domestic corporation if not for the rules specific to REITs
- • Not be a financial institution or an insurance company
- • Be held by 100 or more persons
- • Have 95 percent of its gross income from interest, dividends and real estate transactions
- • Have 75 percent of its gross income from real estate transactions or temporary investment income
- • Distribute at least 90 percent of its income on an annual basis

Captive REIT definition

- A REIT where the shares are not regularly traded on an established securities market, and more than 50 percent of the voting power of the beneficial interests or shares are owned or controlled, directly or indirectly, or constructively, by a single entity that is:
- • Treated as an association taxable as a corporation under the IRC and
- • Is not exempt from federal income tax under IRC §501(a)

Background

- Congress created REITs in 1960 to encourage pooled investments in income producing real estate
- Internal Revenue Code §856 – §860
- To ensure investment in Real Estate market:
  - Must be widely held (by 100 or more investors)
  - Must distribute at least 90 percent of its earnings as a dividend in order to avoid imposition of federal tax on the RIET income
  - Avoids taxation at the corporate level through a dividend paid deduction

Background – continued

- Early 1990s, big accounting firms including Ernst & Young and KPMG LLP determined that they could save client state tax dollars by using REIT's dividend paid deduction together with a corporate structure where dividends were received by a related entity not subject to state taxation.
  - REIT Holding Company located in a state that did not tax dividends received or partially taxed such dividends
  - Related company with no nexus in separate entity states or outside the scope of the combined group
  - Captive insurance company or offshore (80/20) subsidiary that may not be subject to combination

Structure

- The structure involved setting up captive REITs where the parent company constructively owned a majority of the shares, often 99 percent or more, and usually all of the voting shares of the REIT, and then upper management or other closely related parties were given minimal number of shares to meet the 100 shareholder requirement.

Structure – continued

- Real estate assets of the company, often retail stores or portfolios of mortgage loans, are transferred from the company to the REIT in a tax free transfer under IRC §351.

Structure – continued

- Retail stores pay rents to the REIT, or for mortgage REITs mortgage payments and interest are paid to the REIT creating income to the REIT. The company receives a deduction on their state tax return for the rent paid, upkeep and continued construction on the properties, or for the costs to service the loans.

Structure – continued

- The REIT pays no tax at the REIT level as it distributes its income and receives a dividend paid deduction. The entity receiving the dividends may then loan the money back to the parent company or pay out a non-taxed ordinary domestic dividend to the parent company.

Rental REITs

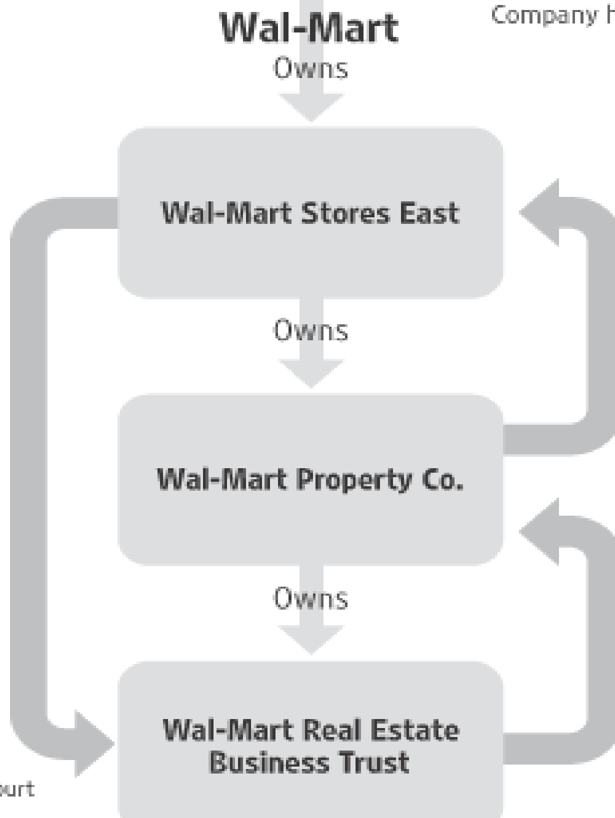
- Common to large multi-state retailers where the REIT holds the property (stores) directly. The in-state operation transfers money to the REIT through rental payments, often tied to a percentage of sales at the retail location. The REIT may file tax returns in a state, but shelters the income through the dividend paid deduction.

Tax Relief

Wal-Mart has cut its tax bills in about 25 states using a sophisticated real-estate strategy:

AP

Company headquarters in Bentonville, Ark.



1. Wal-Mart Stores East pays rent to its real estate trust.

2. The trust pays dividends to Wal-Mart Property Co., therefore avoiding state taxes. The Property Co. also pays no state taxes. It is based in Delaware, which doesn't tax this type of income.

3. Wal-Mart Property Co. pays dividends to its parent, which deducts them from its state taxes because they come from a subsidiary.

Sources: Wal-Mart court filings; WSJ research

Mortgage REITs

- Common to the multi-state banking industry where the REIT holds mortgages or mortgage backed securities. The in-state operation continues to accrue expenses of originating loans and other related costs of managing the portfolio. The mortgage interest accrues as income to the REIT. The REIT may file tax returns in a state, but shelters the income through the dividend paid deduction. In addition, factor numerator amounts, especially relating to the sales and property factors may be excluded from the state's apportionment fraction, thus understating the portion of income that is properly attributable to the state.

Tax Free transfer under IRC §351

- IRC §351 is a huge loophole in state taxation since it allows tax-free transfers of property to related entities located outside of the taxing jurisdiction. By contrast, when transfers are made outside of the federal taxing jurisdiction (i.e. to a subsidiary located in a foreign country) the IRC deems taxable income under IRC §367 to the domestic transferor. The states do not have the equivalent of IRC §367 for transfers to a non-tax state.

Dividends

- REIT dividends paid to a foreign entity are subject to a 15% federal withholding tax, but states don’t have similar laws.
- Because captive REITs can usually only pay taxable dividends to a domestic company to avoid the federal withholding tax, combined filing states are not as vulnerable as separate entity states.
- Potential holes – captive insurance companies or 80/20s.
- Some argue REIT and the REIT shareholder are non-unitary

MTC Findings

- MTC feels that the captive REIT ploy is extremely prevalent and states need to take it more seriously than they have.

Legislative Fix – MTC

- MTC model statute or similar legislation has been adopted by 16 states and eliminates the dividends paid deduction at the REIT level requiring the REIT to pay state taxes on its income. Depending on the tax structure in the individual states, this may or may not eliminate the problem. For example, the REIT may not have nexus for separate entity states and thus avoid taxation in those states (even though related corporations doing business in these states may be claiming deductions for expenses paid to the REIT.)

Legislative Fix – Utah

- Utah has taken a different approach. Utah requires the combination of captive REITs by adding back the dividend paid deduction, and subtracting the dividend received from the REIT by the taxpayer controlling the captive REIT. By doing this the captive REIT is clearly unitary with the other members of the unitary group, and is combined under Utah statute.

Other income shifting strategies

- Attempting to use Foreign Operating Companies under Utah law to exclude income that doesn't arise from foreign operations
- Use of insurance companies (especially captive insurance companies) to shelter income
- Use of other types of companies to shift income

Questions?